



CENTRAL BANK OF NIGERIA



THE NIGERIAN FINANCIAL SYSTEM AT A GLANCE

Monetary Policy Department

The Nigerian Financial System

“The Nigerian Financial System at a Glance” is a literacy publication of the Monetary Policy Department of the Central Bank of Nigeria. It is designed to enlighten the public about basic concepts of monetary policy and central banking.

The book simplifies and presents the concepts in a manner that can be easily understood by users who may or may not have had formal training in monetary policy or central banking. The write-up is sumptuously accompanied with pictorial embellishments for a more reader-friendly presentation.

The publication would be highly beneficial to public policy makers and analysts, businessmen, public sector administrators, professionals, students, and others, who desire to understand the rudiments of monetary policy. Readers would benefit from a beautiful and well discussed menu of monetary policy concepts and related subjects. The book is readily available in libraries across the nation and updated periodically. Enjoy the experience of a well-researched and packaged literacy material!

Dr (Mrs.) Sarah O. Alade

DG Economic Policy Directorate
Central Bank of Nigeria

Acknowledgments

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We regret and take responsibility for any errors observed in the book

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March 2017

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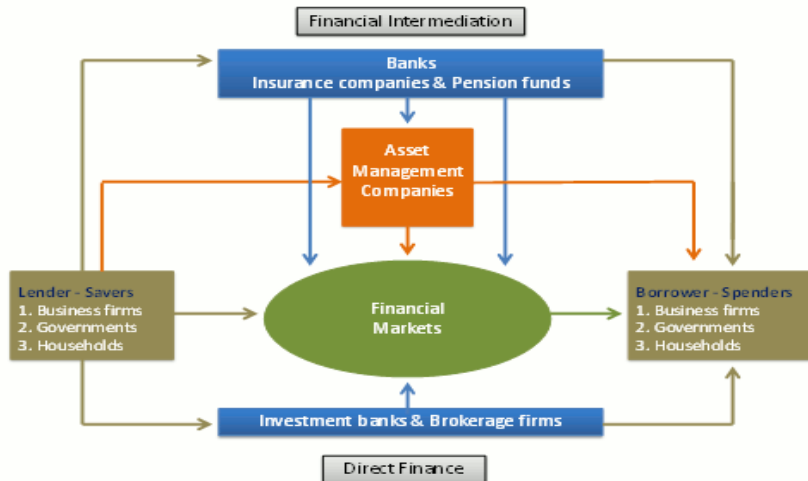
The Financial System

The financial system includes all financial intermediaries that operate in the financial sector in the economy.

It is anchored on the belief that economic agents are categorized into surplus and deficit spending units. The surplus spending units are individuals, groups or organizations operating within the economy that have excess funds above their immediate needs. They constitute suppliers of surplus funds to the financial system. The deficit spending units are those that have a shortage of funds and thus require borrowing to fund their operations. They are the users of the excess funds supplied by the surplus spending units in the financial system.

The financial system provides an enabling environment for economic growth and development, productive activity, financial intermediation, capital formation and management of the payments system. With intermediation, savers lend to intermediaries, who in turn lend firms and other fund using units. The saver holds claim against the intermediaries, in form of deposits rather than against the firm. These institutions provide a useful service by reducing the cost to individuals, of negotiating transactions, providing information, achieving diversification and attaining liquidity.

Structure of a Financial System

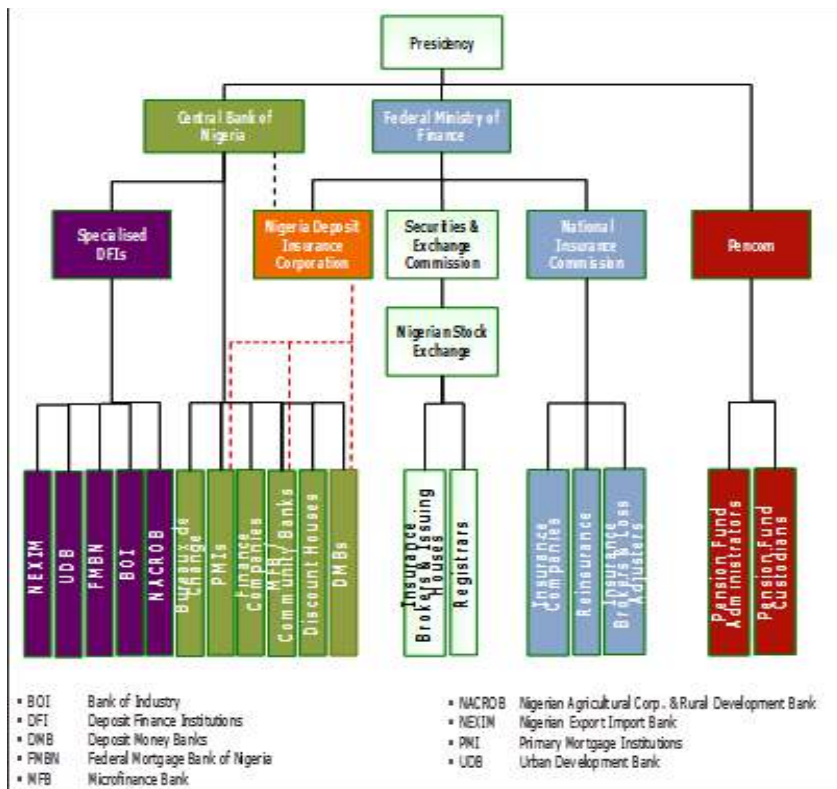


An Overview of the Nigerian Financial System

The Nigerian financial system includes financial markets (money and capital markets), financial institutions including the regulatory and supervisory authorities, development finance institutions (Urban Development Bank, Nigerian Agricultural and Rural Cooperatives bank) and other finance institutions (insurance companies, pension funds, finance companies, Bureau de change, and Primary Mortgage Institutions), among others. It also offers financial instruments (e.g. treasury bills, treasury certificates, central bank certificates),

The structure of the Nigerian Financial System has been through remarkable changes, ranging from their ownership structure, the length and breadth of financial instruments used to the number of institutions established, regulatory and supervisory frameworks as well as the overall macroeconomic environment within which they operate. The Nigerian Financial System also consists of interrelationships among the persons and the bodies that make up the economy. Commercial banks are the most relevant financial institutions in Nigeria to encourage and mobilize savings and also channel savings into productive investment units.

Overview of the Nigerian Financial System



Structure and Role of the Nigerian Financial System

The Nigerian financial system consists of the formal sector (bank and non-bank financial institutions) and the informal sector (savings and loan association, local money lenders, etc.).

The institutions are regulated by the Central Bank of Nigeria (CBN), Federal Ministry of Finance, Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), the National Insurance Commission (NIC), and the Federal Mortgage Bank of Nigeria (FMBN).

The informal sector is largely loosely organized without any form of formal regulation. To interpret the financial system and evaluate its performance requires an understanding of its functions in the economy. With reference to the allocation of resources and economic efficiency, the financial system performs three major functions, which are vital to economic growth and development. First, the system provides convenient and efficient payments system without which specialization in production, so vital to productivity improvements would be greatly impeded. Secondly, the financial system pools savings from net surplus units and channels them to productive investment.



Role of the Nigerian Financial System

A sound financial system is critical to economic growth. It enhances economic performance of the players by improving the overall welfare of the people. The financial system provides a platform for financial infrastructure to help allocate resources to individuals/units that are potentially more productive, to invest those resources.

The financial system gives room for more efficient transfer of resources/funds. In any economy, problems of inefficient allocation of financial resources and information asymmetry may arise as one financial institution possesses superior information than the other parties.

The financial system provides a balance between those who have funds to invest and those in need of funds, if the problem of information asymmetry is solved. The transfer of funds from surplus units (mainly household) to deficit units (mainly business, government and some households) can take place directly, while direct finance, as the process is called is inconvenient both for ultimate provider of funds and the ultimate user of funds.

Main Functions of Commercial Banks

Payments

- Traditional Options (Cheques, DD)
- Modern (Wire transfers, ECS)

Financial Intermediation

- Take deposits
- Lend
- Address safety and liquidity, growth needs

Financial Services

- Forex
- Wealth Mgmt
- Insurance
- Investment Banking

The Informal Sector

The informal sector covers a wide range of market activities. First, the informal sector is formed by the coping behavior of individuals and families in an environment in which earning opportunities are limited. Second, the informal sector is a product of rational behavior of entrepreneurs that desire to avoid state regulations, which simply means they operate outside the regulatory purview of the government.

The informal sector engages in activities which are not easily measured and it cuts across a wide range of areas of informality — environmental, spatial, economic, and social, covering business activities, employment, markets, settlements, and neighborhoods. These activities include casual jobs, subsistence agriculture and unpaid jobs. Each of these areas have implications for public policy formulation and implementation.



Composition of the Informal sector

Local money lenders, Money changers, Pawn brokers, Thrifts and Savings Associations.

The Local Money Lenders

The Local Money Lenders are individuals or group of individuals that are wealthy enough to lend part of their financial resources to others at a price. The locals approach the money lenders to raise short term funds for petty trading, farming, social functions, etc. The interest rate for the facility is usually high and largely uncollateralized. The scope of local money lenders is small given the fact that funds are made available to only known persons and the amount involved is usually small.

Both principal and interest are paid back at agreed (between lender and borrower) installments or at once.

Some Local money Lenders engage in 'hire-purchase' arrangement by availing motor cycle (Okada) to riders (borrowers) while principal and interest are paid back to the lender from their daily proceed.

Although, advancements in the financial system have led to virtual extinction of Local Money Lenders in the Country, they still exist in various localities.



Savings Associations

Savings imply withholding something valuable for future use rather than consuming it immediately. This describes two types of any savings activity such as Discipline and Sacrifice. Implying that for one to save, he/she requires high level of discipline as savings involves a lot of sacrifice. The savings association is an association of two or more people that come together to contribute money or goods to a common fund which is given in whole or in part to each contributor in turn. The Association lends money to interested customers at an interest, who then uses the money to either invest or start up new business.

The picture depicts in a simple way, the process of saving and borrowing money for either consumption or investment. For a savings association or group to succeed, there are key factors that influence its success. They include Common Bond, Discipline, Team Spirit, Trust, and a clear savings objective, etc. These factors are critical to a successful savings association. People save for a variety of reasons: To prepare for future emergencies or risks (natural disasters, injuries, death), otherwise known as the precautionary motive of holding money, to educate their children, prepare for old age and disability, invest in opportunities etc.



Formal Sector

Central Bank of Nigeria

The Central Bank of Nigeria is a monetary authority that manages the currency of a country or group of countries and controls the money supply, i.e. the amount of money in circulation. The primary goal of many central banks is price stability. In some countries, central banks are also required by law to act in support of full employment.

One of the main tools of any central bank is setting interest rates – the “cost of money” – as part of its monetary policy. Most central banks do not engage in retailing banking and an individual cannot open an account or ask for credit facilities/loans.

It acts as a bank for the deposit money banks and this is how it influences the flow of money and credit in the economy to achieve stable prices. Commercial banks can turn to the central bank to borrow money, usually to cover very short-term needs. The main activity of most central banks is tied to liquidity management, which involves the routine control of the level of money supply in the system in order to minimize fluctuations in banks reserve balances. Periodically, the Central Bank of Nigeria determines target growth rates of money supply, which are compatible with overall policy goals. It also seeks to align commercial and merchant banking activities with the overall target.



CENTRAL BANK OF NIGERIA

Nigeria Deposit Insurance Corporation (NDIC)

The Nigeria Deposit Insurance Corporation is another agency of the Federal Government of Nigeria that operates independently. The overall objective of the NDIC is to protect depositors and guarantee payment of insured funds in the event of failure of insured institutions.

The establishment of NDIC and its commencement of operation in 1989 was the manifestation of a shift in banking regulation away from bank bailout and imposed management of failed or failing banks towards protecting depositors.

The operations of the NDIC in conjunction with that of the CBN is part of a three-way safety net strategy that includes deposit insurance, last resort lending and supervision designed to provide some level of protection against losses owing to failure and insolvency. The NDIC is empowered to work out the modalities for the assets and liabilities of a failed bank to be taken over by another bank. For example, in October 2007 the United Bank for Africa assumed the fixed assets and private sector deposit liabilities of African Express Bank under the supervision of the CBN and the NDIC.



Nigeria Security and Exchange Commission (SEC)

The Nigeria Securities and Exchange Commission was established in 1962, when an ad hoc consultative and advisory body, known as the Capital Issues Committee, was established under the supervision of the Central Bank of Nigeria (CBN). Its main function was to process applications from companies seeking to raise capital from the capital market and recommend the timing of such issues to prevent issues clustering which could overstretch the market's capacity. The Committee operated within the Central Bank of Nigeria unofficially as a capital market consultative and advisory body with no regulatory framework. Currently, in regulating the market, the Commission performs the following activities in order to protect investors, market operators and also ensure market integrity. Registration of securities and market intermediaries to ensure that only fit and proper persons / institutions are allowed to operate in the market. Inspection either done "onsite" or "off-site". Surveillance is also carried out over exchanges and trading systems to forestall breaches of market rules. Investigation of sharp practices against laws and regulations governing the capital market, and appropriate enforcement actions are taken against market operators who are found wanting after investigation is carried out. This is to ensure that the Commission meets up with international best practices and enhance financial system stability.



More on the Nigeria Stock Exchange

The Nigerian Stock Exchange plays a dominant role in championing the development of Africa's financial markets. Registered as limited company by guarantee and it is licensed under the Investments and Securities Act (ISA) and is regulated by the Securities and Exchange Commission (SEC) of Nigeria. The Exchange offers listing and trading services, licensing services, market data solutions, ancillary technology services and more.

The NSE has undergone changes in order to meet the needs of its valued customers and to achieve the highest level of competitiveness. It is an open, professional and vibrant exchange, connecting Nigeria, Africa and the world. Ownership of the Exchange is made up members/brokers, who not only exclusively trade listed securities, but also originate new listings and act as the registrars. Besides Lagos, the Exchange has six branch offices. Trading occurs via intranet connection (Automated Trading System (ATS) for trades & CAPNET for information services/supervision) with settlements effected by the CSCS (Central Securities Clearing System) a subsidiary of the Exchange.

STOCK EXCHANGE

THE Nigerian
STOCK EXCHANGE



Deposit Money Banks (DMB)

Commercial banks, also referred to as Deposit Money Banks (DMBs) are financial intermediaries that provide services, such as accepting deposits, granting of business loans, mortgage lending, and basic investment products like savings accounts and time deposits etc. Deposit Money Banks; act as financial intermediaries to channel savers' monies to firms and individuals who seek funding for their activities. They act as a catalyst to facilitate economic growth/development widely recognized by both monetary and development economists. The financial system of Nigeria is dominated by the banking sector, especially the deposit money bank which provides the foundation for the development of the financial system. Their credit component constitutes a major link between the monetary sector and the real sector of the Nigerian economy. Deposit money banks mobilize financial resources and allocate them to productive investments to promote sustainable economic performance and facilitate a vibrant real sector. They not only store our saved cash and lend us money when we need it, but act as the system of arteries that transport money around the economy; which is why they are often known as financial intermediaries. Hence their key function is to transfer surplus money from those who want to lend to those who want to borrow.



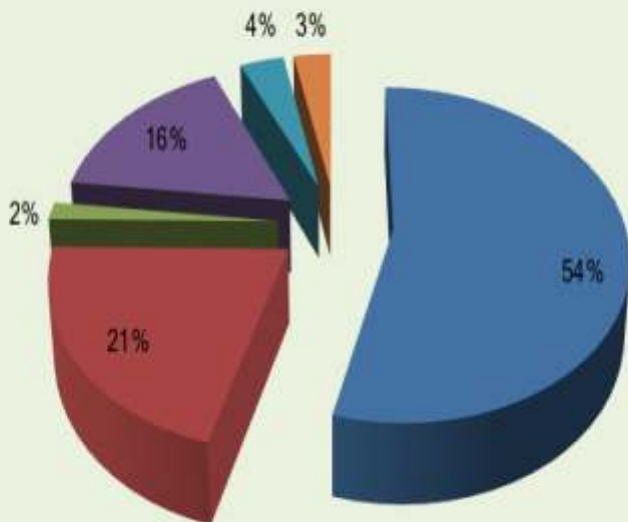
Debt Management Office

The DMO was established on 4th October, 2000 to centrally coordinate the management of Nigeria's debt, which was hitherto being done by a myriad of establishments in an uncoordinated fashion. This diffused debt management strategy led to inefficiencies. For instance, in the FMF alone, four different departments have functions for the management of external debt in the following format: External Finance Department; Multilateral Institutions Department; Africa and Bilateral Economic Relations (ABER) Department; Treasury Department (OAGF) and Foreign Exchange and Trade Relations Department.

The establishment of the DMO marked the beginning of the institutionalization and professionalization of public debt management in Nigeria. In the DMO's continuous efforts to strategically develop and deepen the FGN Bond market the following initiatives, amongst others, were undertaken: For example, the diversification of holding structure of FGN securities away from the dominance of the CBN, such that the private sector now holds nearly all Government Securities; the streamlining and restructuring of the different types of debt instruments through tenor elongation and establishment of sovereign yield curve of 3 months to 20 years etc.

FGN's DEBT STRUCTURE

■ FGN BONDS ■ NTBs ■ TREASURY BONDS
■ EXTERNAL - MULTILATERAL ■ EXTERNAL - BILATERAL ■ EUROBONDS



June 30, 2016

Finance Companies

A finance company, comprises of a person or company licensed to carry out finance company business. Finance Company Business means the business of providing financial services for consumers and to industrial, commercial, or agricultural enterprises. Such services include: Funds management; Equipment leasing; Hire-purchase; Debts factoring and securitization; Project financing or consultancy; Debt administration; LPO financing; Project financing; Export financing; Financial consultancy; and Issuing of vouchers, coupons, credit cards and token stamps and such other businesses as the CBN may, from time to time, assign. Finance is the process of channeling these funds in the form of credit, loans, or invested capital to those economic entities that require finances or can put them to the most productive use. These institutions act as financial intermediaries and they include commercial banks, savings banks, savings and loan finance associations, and such nonbank institutions as credit unions, insurance companies, pension funds, investment companies, and finance companies.



Insurance Companies

Insurance firms constitute one of the important segments of the Nigerian financial system. The primary objective of insurance companies is to protect their customers against insured risks by selling insurance policies to them. The policy holders pay premium to the insurance firms while expecting compensation from them in event of the occurrence of the insured risks.

In addition, Insurance Companies pool and manage risks on behalf of their customers. Hence, insurance provides a risk transfer mechanism for households individuals, business firms and government agencies. Due to the risk exposure an individual faces every day, Insurance Companies have developed different policies that cover almost all the risks. They manage the risks of individuals and allow people to share their liabilities by pooling individual risks and reducing the chances of suffering financial lost or devastation. It's activities covers areas of life insurance, health, automobile, security, homes, profit and claims among others.

Insurance is based on the principles of large numbers and the engagement of the hitherto ignored informal sector can contribute significantly to building the numbers. In this regard, insurance companies need to work more on their customer service and claims management in order to yield good returns. The magic of technology remains pivotal to service delivery in modern times and brings benefit to the industry

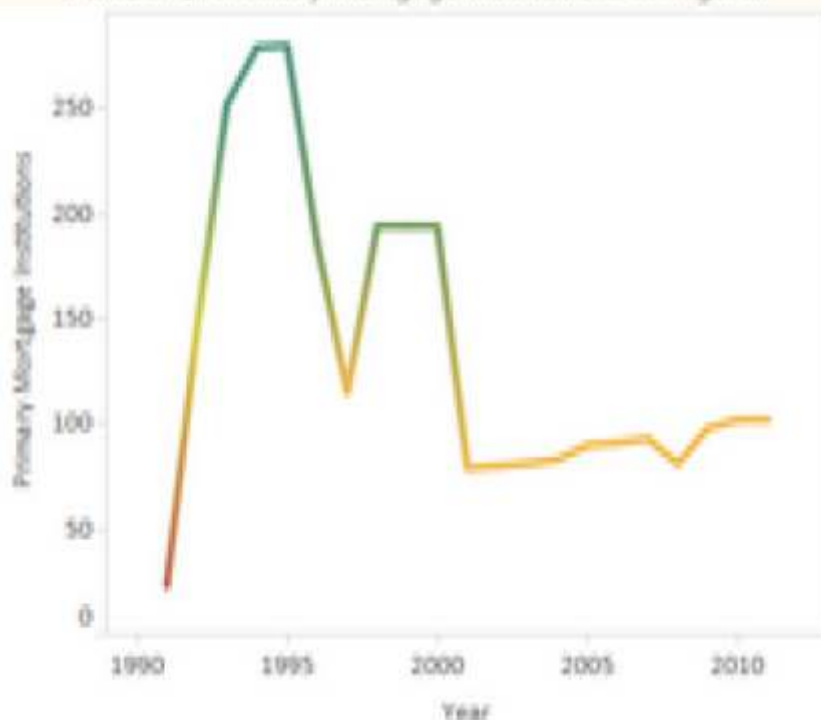


Primary Mortgage Institutions

A Primary Mortgage Institution [PMI] refers to any company that is licensed to provide mortgage services in Nigeria. Mortgage business in this case includes the following:

- Granting of loans or advances to any person for the building, improvement or extension of a dwelling/commercial house;
- Granting loans and advances to any person for the purchase or construction of a dwelling/commercial house;
- Accepting savings and deposits from the general public and paying interest thereon;
- Managing pension funds/schemes;
- Rendering of technical advisory services for the purchase or construction of a dwelling house;
- Performing estate management duties;
- Offering project consultancy services for estate development;
- Engaging in estate development through loan syndication, subject to the restriction imposed by the shareholders' funds unimpaired by losses;
- Embarking in property trading including land acquisition and disposal;
- Engaging in other services which management of the Central Bank of Nigeria may approve from time to time.

Number of Primary Mortgage Institutions in Nigeria



Source: CBN, <http://www.cbn.gov.ng/>

Naira Charts

Bank of Industry (BOI)

The Bank of Industry Limited (BOI) is the largest and most successful development financing institution. It was founded in 2001 following a reconstruction of the Nigerian Industrial Development Bank (NIDB) Limited, which was established in 1964. The International Finance Corporation held 75% of its equity along with a number of domestic and foreign private investors at inception. The authorized share capital was initially set at N50 billion in the wake of NIDB's reconstruction into BOI in 2001, and it has been increased to N250 (Two Hundred and Fifty Billion Naira) in order to put the bank in a better position to address the nation's rising economic demands in line with its mandate.

After, a successful institutional, operational and financial restructuring programme embarked upon in 2002, the bank has transformed into an efficient, focused and profitable institution that is well placed to effectively carry out its primary mandate of providing long term financing to the industrial sector of the Nigerian economy. The main objectives of the bank is to increase output, generate employment, diversify the revenue base, increase foreign exchange earnings and provide inputs for the industrial sector on a sustainable basis.



Nigerian Export-Import Bank (NEXIM)

The Nigerian Export-Import Bank (NEXIM) was established by Act 38 of 1991 as an Export Credit Agency (ECA) with a share capital of N50,000,000,000 (Fifty Billion Naira) held jointly by the Federal Ministry of Finance Incorporated and the Central Bank of Nigeria. The Bank which replaced the Nigerian Export Credit Guarantee & Insurance Corporation earlier set up under Act 15 of 1988 has the following main statutory functions:

Provision of export credit guarantee and export credit insurance facilities to its clients; Providing credit in local currency to its clients in support of exports; Management of funds connected with exports. Maintenance of a foreign exchange revolving fund for lending to exporters who need to import foreign inputs to facilitate export production; Provision of domestic credit insurance where such a facility is likely to assist exports and provision of trade information system in support of export business.

The Bank presently provides short and medium term loans to Nigerian exporters. It also provides short term guarantees for loans granted by Nigerian Banks to exporters as well as credit insurance against political and commercial risks in the event of non-payment by foreign buyers. The Bank is also the government's National Guarantor under the ECOWAS Inter-state Road Transit programme.



Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB)

BOA is Nigeria's pioneer agricultural and rural development finance institution, owned by the federal government of Nigeria. The Federal Ministry of Finance Incorporated and Central Bank of Nigeria (CBN) ownership structure is 60% and 40% respectively. Bank of Agriculture Limited is supervised by Federal Ministry of Agriculture. The Bank was incorporated as Nigerian Agricultural Bank (NAB) in 1973 and in 1978; the name was changed to Nigerian Agricultural and Cooperative Bank (NACB). In 2000, it was merged with the People's Bank of Nigeria (PBN) and took over the risk assets of Family Economic Advancement Programme (FEAP) to become Nigerian Agricultural Cooperative and Rural Development Bank Limited (NACRDB). The bank's primary responsibility is to ensure effective delivery of agricultural and rural finance services on a sustainable basis to support the national economic development agenda, including food security, poverty reduction, employment generation, reduction in rural to urban migration, less dependency on imported food items, and increase in foreign exchange earnings. Agricultural value chains activities are also supported by the services of the bank.



Bureau de Change

A Bureau de Change [BDC] is company that is licensed to provide small scale foreign exchange services in Nigeria and whose sole object is the carrying on of such businesses on a stand alone basis.

In Nigeria, Bureau de Change services are limited to: dealing in bank notes, coins, buying and selling of Traveler's cheques and such other businesses as the CBN may approve from time to time.

The licence of a Bureau de Change in Nigeria provides the holder the rights and privileges of an approved buyer of foreign exchange in keeping with the standard of the financial services industry and in order to ensure and maintain public confidence in the sub-sector.

The Central Bank of Nigeria, reserves the right to revoke the licence of a Bureau De Change if it has reason to believe that it is not in the national interest for it to continue to operate in line with the provisions of CBN Act No. 24, 1991 [as amended] and the Foreign Exchange [Monitoring and Miscellaneous Provision Act] No 17 of 1995.



Financial System Regulatory Framework

Finance and banking operations are governed by rules and regulations which are reviewed regularly to reflect the changing economic environment. Over the years some rules and statutes which govern the operation of the banks were enacted which includes; the Central Bank of Nigeria Decree No. 24 of 1999 as amended; Bank and other Financial Institutions (BOFI) Decree No. 25 of 1991 as amended; the Dishonoured Cheque (Offenses) Decree of 1977; the Failed Bank (Recovery of Debt) Decree No. 18 of 1994 as amended; and the Money Laundering Decree No. 3 of 1995. The National Insurance Commission Decree No. 1 of 1997 and the Insurance Decree No. 2 of 1977 provide the regulatory framework for the operation of the insurance industry. The major regulatory/ supervisory authorities are the Federal Ministry of Finance (FMF), Central Bank of Nigeria (CBN), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), Federal Mortgage Bank of Nigeria (FMBN), and the National Board for Community Banks (NACB). The CBN is at the apex of all banking institutions operating in the money market and has responsibility for controlling and supervising all commercial, merchant and community banks, the microfinance banks, finance companies, discount houses, primary mortgage institutions, bureaux de change, and all development banks.

How to get there?



UNSERVED

- Have no basic bank account
- Have no (or restricted) access to financial services
- Rely on a cash economy



Banks
Microfinance
Institutions
Mobile Network
Operators

Card Companies
Postal Networks
Financial
Cooperatives



SERVED

- Have a transaction account
- Use broad range of financial services



Financial Service Providers

Financial service providers are small businesses who perform different kinds of activities similar to that of the banking sector. Technological advancement in recent times has brought about innovations and opportunities in transacting financial services in the world of money and banking. Using just one word "bank" or just "bank account" targets a specific kind of financial service provider and a specific kind of financial service. In Nigeria today different types of financial service providers exist and compete favourably with the banks which are only one part of the financial industry.

Banks provided financial services such as Savings account, Checking accounts, Interest on checking deposits, Automatic deposit and payment, Credit cards, Check cards or Debit cards, ATMs, Online banking, Storage of valuables (safe deposit boxes), Money transfers, Overdraft protection and Traveler's checks. The financial services industry forms the largest group of companies in the world in terms of earnings and equity market capitalization. The main objective of CBN's financial sector surveillance function is to promote the stability and soundness that would engender public confidence in the financial system.



**FINANCIAL
SERVICES**

Information
Sharing and
Analysis Center

AFFILIATE



Financial System Stability

Financial system stability refers to the absence of systemic risks, shocks or crises in the financial system. It is simply the avoidance of a financial crisis in an economy (Macfarlane, 1999). The emphasis on systemic shocks or crises is important in this definition, as financial instability does not only connote financial ill-health of a particular bank, firm or household, but extended to cover the entire financial system in an economy. According to Foot (2003), financial stability is attained if: monetary stability is achieved; the employment level in an economy is close to its natural rate; the public reposes high confidence in the operations of key financial institutions and markets and there is relative stability in the price movements of both real and financial assets.

In the past, the lack of comprehensive regulatory frameworks by the regulatory and supervisory agencies to prevent, and resolve banking distress / crisis management posed a major challenge to financial system stability. It was against this background that the CBN and the NDIC decided in December, 2001, to put in place the framework on distress resolution address some systemic issues faced by the financial sector. Subsequently, a number of policies have been formulated and implemented to strengthen the financial sector.

Macro prudential considerations

- Enhance buffer role of capital
- Role of diversity in markets; Can government regulator be relied on to identify
 - bubbles vs shifts in fundamentals?
 - Good times vs bad times to reduce procyclicality of capital requirements?

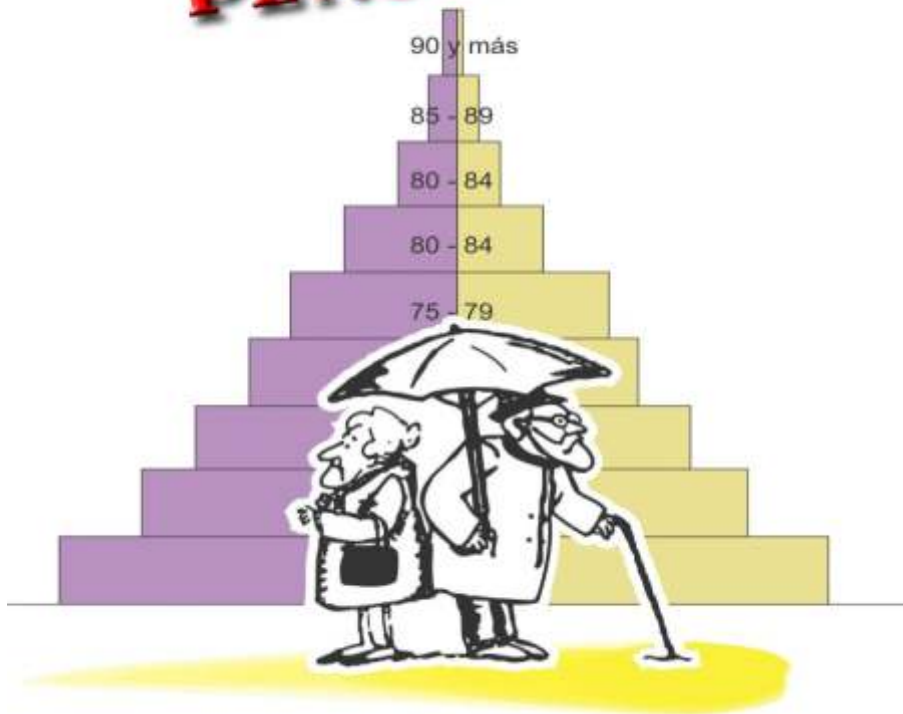
The National Pension Commission (PENCOM)

The National Pension Commission (PENCOM) was established to supervise, coordinate, regulate and control the efficient and effective administration of pension matters in Nigeria. The commission derived its powers to regulate pension activities in Nigeria from the Pension Reform Act 2004 .

The functions of the Commission include:

- To regulate and supervise the Pension Scheme;
- Provide guidelines for the operation and administration/ investment of pension funds;
- Licensing pension fund administrators, supervising custodians and other institutions dealing with pension matters;
- Setting standards and guidelines for efficient management of pension funds under the Act;
- Providing a database for all pension matters;
- Educating the public on pension related issues and how the scheme is managed;
- Building capacity for pension fund administration; and
- Serving as a body to investigate and resolve complaints from the public against any pension fund administrator, custodian or employer.

PENSIONES



National Insurance Commission (NAICOM)

In 1997, the National Insurance Commission was founded to ensure the effective administration, supervision and regulation of insurance business in Nigeria as well as regulate transactions between insurers and reinsurers within and outside Nigeria.

The responsibility to set the standards for the conduct of insurance business in Nigeria was granted to commission for proper monitoring and inspection in order to ensure stability in the industry. It determines and approves the rates for premiums and commissions in the insurance industry and protects policy holders and other beneficiaries of insurance contracts.

It advises the Federal Government on insurance matters and ensures that government assets are protected.

It also contributes to insurance the education programmes of the Chartered Insurance Institute of Nigeria and the West African Insurance Institute.



Federal Mortgage Bank of Nigeria (FMBN)

The Federal Mortgage Bank of Nigeria, an Apex Secondary Mortgage Institution set up to promote development of low interest, affordable and decent houses for low and medium earners towards home ownership nationwide. The key objective is that of sourcing of funds for the provision of affordable residential houses for Nigerians.

The bank Provides credit facilities (loans) to Nigerians for the purpose of building, acquiring or renovating houses. It also, promotes programs that would enhance housing financing among low and medium income earners. The fund Provides long term loans to Mortgage Institutions for lending to contributors of the Fund, and cater for the non-salaried informal sector.

The major players include; brokers, correspondents, mortgage banks, commercial banks, investment banks, and savings associations. Some of these firms are small and local, while others are large and national. Banks and their affiliates make up a large and growing proportion of the mortgage banking industry. Banks that originate or purchase residential loans need to have sound third-party risk management practices.



Financial Services Regulation and Coordinating Committee (FSRCC)

The Financial Services Regulation and Coordinating Committee (FSRCC) was established in April 1994, to facilitate a formal framework for the co-ordination of regulatory and supervisory activities in the Nigerian financial sector conjunction with the CBN, through consultations and regular inter-agency meetings, to address issues of common concern to regulatory and supervisory bodies. The objectives of the Committee are to:

- Coordinate the supervision of financial institutions, especially conglomerates;
- Facilitate the reduction of arbitrage opportunities usually created by differing regulatory and supervisory standards among supervisory authorities in the financial services industry;
- Resolution of problems experienced by any member in its relationship with any financial institution, and bridge any information gap encountered by any regulatory agency in its relationship with any group of financial institutions;
- Develop the strategies for the promotion of safe, sound and efficient practices by financial intermediaries and deliberate on such other issues as may be specified from time to time.



**Financial Services Regulation Coordinating
Committee (FSRCC) Nigeria**

Financial Assets Instruments

Financial Assets are tangible liquid assets whose values are derived from the representation of their contractual claim. Examples are bank deposits, bonds, stocks, and the like. Financial assets do not necessarily have physical worth unlike land, property, commodities or other tangible physical assets. Their values often fluctuate as the assets do not have value before being converted to cash especially in the case of stocks.

On the other hand, monetary contracts among interested parties that can be traded, created, modified and even settled are referred to as financial instruments. Examples are shares depicting ownership interest or bond which connotes contractual right to deliver or receive cash as well as cash (currency).

Another feature is that financial assets are typically more liquid than other assets (tangible), like commodities or real estate. Financial asset may also be traded in financial markets. Assets that can be traded and also serve as packages of capital are financial instruments. They can be cash, contractual rights of delivering or receiving cash or other types of financial instrument or it could in the form of evidence of ones' entity ownership.



More on Financial Assets/Instruments

Tangible assets: The physical form of an asset is described as tangible assets. It involves both fixed and current assets. The fixed assets are land, buildings, machinery while an example of current asset is inventory. These assets are the backbone of a company and keeps it in production but are not available to customers. It can also be defined as an asset that has material form such as cash, equipment, plant, property that can exist in physical form for a long time. Its acquisition is for the operation of the business and not necessarily for sale to customers.

Intangible assets: Intangible assets refer to those assets that are not physical, like goodwill, copyrights, trademarks, patents and brand recognition. They are long-term resources, however, they cannot be touched or felt as they have no physical existence. Generally, these assets are classified into two broad categories: (1) Definite or Limited-life intangible assets, such as goodwill, copyrights and patents and (2) Indefinite or Unlimited-life intangible assets, like trademarks. Also, intangible assets exist in opposition to tangible assets like land, vehicles, equipment, inventory, stocks, bonds and cash. An example of a company's indefinite asset is its brand name since it remains with it throughout its period of operation.

Tangible Assets

Tangible Assets

Equipment
Machinery
Buildings
Vehicles
Stock
Land
Cash



You Can
Touch It

Intangible Assets

Trademarks
Franchises
Copyrights
Licenses
Goodwill
Patents
Brands



You Can't
Touch It

Characteristics of Financial Assets

Moneyiness: The ability to easily convert an asset into cash within a defined time frame and determinable value is referred to as the moneyiness of a financial asset. The implication of financial assets being moneyiness is the ease of convertibility to cash in a clearly distinct time period. There is agency cost by way of securing funds before the date of maturity in addition to the cost of discounting aimed at reducing the face value. As a result of the ease with which these financial instruments can be traded for cash, they are regarded as near money. Trade bills, treasury certificates, treasury bills, commercial papers, certificate of deposits etc are some of the examples of these financial instruments. Divisibility & Denomination: Depending on the face value set out by corporate institutions and organisations, financial assets usually are presented in various denominations in the course of raising funds in the financial markets. Financial assets are often divided into minimum monetary value by the holder to ensure the liquidation or the process of exchange by the holder. Generally, Divisibility and denomination have to do with the minimum quantity or size of trading in assets.



Characteristics of Financial Assets

Reversibility: Since they act as customers' deposit account, financial assets are extremely reversible. There is a negligible cost involved in investing in financial assets and its reversal. As a result of this negligible cost, the process of reversing financial assets is often seen as roundtrip or turnaround cost. The significant part of these costs is referred to as 'bid-ask spread' for entrenching delivery cost of the commission. Where financial market is well organized, market makers take responsibility to assume risk is associated with financial asset. Thus, market makers charges for spread vary along the financial asset that is being traded.

Cash Flow: When an investor holds a financial asset, he/ she is expected to derive some returns depending on cash distributions of the asset to holders. Dividend on shares or payment on coupon yields associated with bonds. A financial asset returns on investment also is influenced by repayment principal in terms of debt instrument and shocks expected price variation. In the course of calculating financial assets' expected returns, we will have to factor non-cash payments such as yield in stock dividend and additional stock purchase.

- reversibility
 - cost of buying asset, then selling it
 - deposits--near zero
 - stocks--commissions
 - costs low for thick markets
 - Tbill market
 - costs higher for thin markets
 - small company stocks

Characteristics of Financial Assets

Maturity: Maturity in the context of financial assets refers to the period of time within which a financial instrument held before it is repaid to the holder. For example, a corporate body can hold a bond for thirty (30) years and a government can extend the period to say ninety-nine years before repayment to the holders. However, it is the case that some financial instruments may not reach the stated maturity date before they are terminated due to bankruptcy, reorganisation, call provision, etc.

Convertibility: Financial assets and instruments that pay regular interest can be converted to other assets and instruments on condition that prices are appreciating to a predetermined level. The convertibility characteristic implies that a financial instrument or asset can be converted into another asset class. The conversion can be done by the same corporate body that held the financial asset or instrument to continue to raise funds for its operations. The nature of the conversion can take various forms. For instance, preference shares can be converted to equity shares, while bonds can be converted to equity shares.



Characteristics of Financial Assets

Predictable Returns: For investors to patronize financial assets, their returns must be predictable. The percentage of interest accruable to a certain debt instrument should be known to investors before they are ready to stake their funds on such instrument. This is meant to avoid manipulation of records by Boards and Managements. The classical unwholesome accounting practices perpetuated by Cadbury in Nigeria and Enron in the US are great testimonies of management manipulation of records to deceive the investing public.

Returns & Tax Status: The returns associated with financial assets being taxable earnings are subject to tax status. The interest of tax authorities are in collection of taxes on earnings associated with financial assets which are regarded as securities and investors' income. However, status of tax on financial assets is not the same as they vary from one economy to another. Also, variation of such tax rate is equally the case from time to time on financial assets and this depends on the interest of the government which is expressed through the tax/fiscal authority. The status of tax on financial assets also differ in terms of one security type and the other based on the issuing institutions or companies in terms of being Federal, State, or local government.

Liquidity & Returns

- In almost all cases, liquidity is inversely correlated with returns
- Examples:
 - Cash = very liquid
 - Private equity = very illiquid
- Common mistake: Safety!
= Liquidity



Types of Financial Assets Instruments

Equity Instruments: This is a document that can legally serve as evidence of ownership right in a firm such as share certificate. It is usually issued to shareholders of companies for funding the business. There are various categories of equity instruments such as common stock, convertible debenture, preferred stock, depository receipt, transferable subscription right (TSR). Common stock is used by a public company for the purpose of raising funds from the public. In this arrangement, shareholders have the privilege of being co-owners of a company and also the right to vote at the meeting of shareholders taking cognizance the proportion of their shares. In addition, it is within their rights to be involved in taking important decisions on issues like raising capital for payment of dividend.

Debt instruments: These are Assets that require a holder to be paid a fixed amount of money, usually with interest. Mortgages and bonds, both corporate and government, are examples of debt instruments. The market for equity which is also known as stock market is where equity instruments are traded.

Money



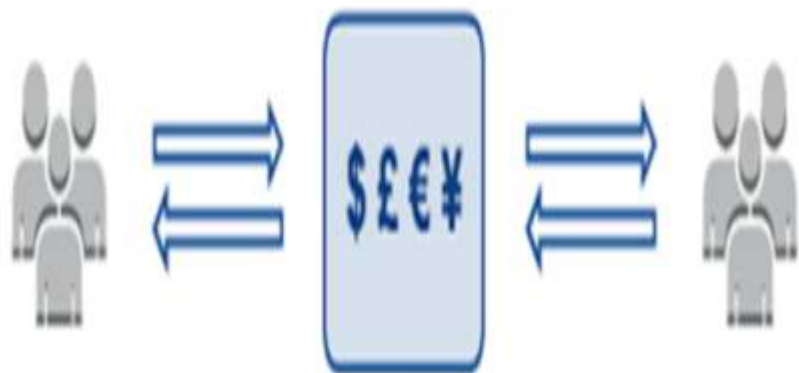
Stocks

Bonds



Denomination of Financial Assets

Generally, financial assets of different countries are denominated in their different currencies. For instance, the Nigerian financial system financial assets are denominated in Naira. Some of these assets are treasury certificates, treasury bills, federal government loan stock, shares and corporate and state government bonds. The assets in U.S. are denominated in dollars, the financial assets in United Kingdom (UK) are denominated in pound sterling, and those in China and Japan are denominated in Yuan and Yen respectively. In South Africa and Ghana, they are denominated in Rand and Cedi respectively. These financial assets are used for transaction and are denominated in different currencies. Despite the existence of different currencies worldwide, some financial assets (currencies) are traded internationally and not only for the domestic market alone. These are the financial instruments used in the highly developed capital markets like U.S., U.K. Japan, France etc. In these economies, financial assets are usually denominated in American dollars and any other international currencies like the pound sterling, euro, yen, yuan that are acceptable around the world. These international currencies are also said to be internationally convertible.



Savers /
Creditors

Financial
Instruments

Financial
Markets

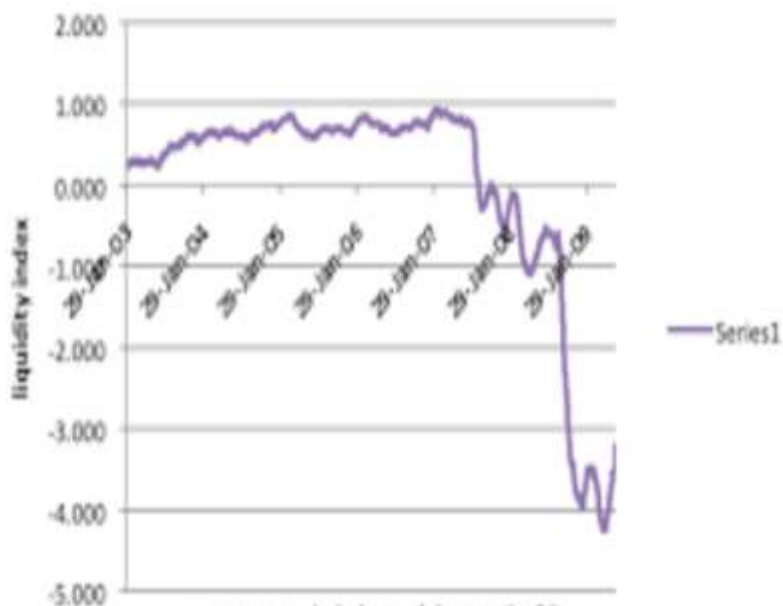
Financial
Instruments

Lenders /
Debtors

Liquidity of Financial Instrument

The classification of financial instrument as near money stems from the fact that they are highly liquid. This feature arises from the simplicity of exchanging them for cash. Typical instances of highly liquid financial instruments are; treasury certificates, bills of exchange, treasury bills, shares of blue chip entities like GTB, First Bank, Cadbury etc. However, when it is difficult to convert financial instruments easily into cash as the need arises, it is said to be illiquid. In this instance, the holder may need to hold it till maturity or it could only be traded at very trivial value in the capital markets where jobbers are interested in holding them as part of in their securities' stock. It must be noted that jobbers are not available currently in Nigeria's Stock Exchange. Thus, brokers in the Nigerian stock exchange are often not interested in trading in financial instruments of weak corporate entities.

Financial Market Liquidity



www.economicshelp.org | Source: B of E

The Financial Market?

The financial market is a setting in which there is an exchange by people of commodities, financial securities and other valuable items at transaction costs that reflect demand and supply conditions. Some of these securities are bonds, stocks and commodities as well as agricultural products and precious metals.

Within the financial sector, the term financial market is often used to refer just to the markets that are used to raise finance which may be long term such as capital market or short term such as money market. The term can also be used generally for all markets in the financial sector such as capital market made up of stock and bond markets, commodity market, money market, derivatives market, futures market, foreign exchange markets and spot market, interbank market.

It is also possible to further divide the capital market into primary and secondary markets. New securities are sold in the primary market such as initial public offerings while investors buy and sell securities in the secondary market.



Structure of Financial Markets

Classification by Nature of Claim

Equity market: This is the market where equity instruments are traded. It is also referred to as the stock market. Some examples of equity instruments can be found in the Nigerian Stock Exchange where they are traded. These include common stocks. Equity market is also the market for exchanging long-term securities in excess of one year. It is also a market that is used to secure finance for capital investment. Within the capital market, stock market component is the largest and is dominated by institutional and private investors.

On its part, the bond market which is also referred to as debt or credit market is a financial market for issuing new debts by participants and this is known as primary market. The other component of the market for buying and selling debt securities is known as the secondary market, usually issued in the form of bonds, notes, bills, etc. The bonds market is where investors trade (buy and sell) debt securities, prominently bonds.



Structure of Financial System

Classification by Maturity of claim

Money market: This is a market for trading financial instruments that are considered to be of high liquidity with very short maturities. In the short term, it provides participants a window to borrow and lend for a period of overnight to one year. The securities traded in the money market are particularly IOU by large corporations, governments and financial institutions and are extremely safe and liquid.

Capital market: This is a financial market whereby equity-backed securities and long-term debt are traded. It is a market where funds are made available for more than one year for investment. The wealth of savers in the capital markets is channeled to those who are ready to put them into long term productive investments. These investors can be government agencies or private companies. In order to protect investors against fraud and other sharp the practices, the Securities and Exchange Commission (SEC) oversees the activities of the capital market in Nigeria.



Structure of Financial System

Classification by Season of Claim

Primary market – Public Issue market: this market is part of the capital market involved in the issuance of new securities. It is involved in creating long term instruments for corporate bodies to source for funds in the capital market. In this market, public sector institutions, companies and governments raise funds through the issuance of bonds while corporations raise funds by selling new stocks under the initial public offering (IPO). Finance syndicate of security dealers and investment banks provide the avenue for this exercise to be carried out. Investors buy new shares through the process of underwriting with dealers earning commission that is built into security offering price even though it could be in the prospectus.

Secondary market – also called aftermarket. This is a market where previously issued financial instruments are traded. These instruments include bonds, options, stocks, futures. The secondary market is also used as a reference market for the display of goods or assets that have been used or in the case where existing assets or products can be used in an alternative way.

Structure of Capital Markets

Primary Markets	Secondary Markets
When companies need financial resources for its expansion, they borrow money from investors through issue of securities.	The place where such securities are traded by these investors is known as the secondary market.
Securities issued a) Preference Shares b) Equity Shares c) Debentures	Securities like Preference Shares and Debentures cannot be traded in the secondary market.
Equity shares is issued by the under writers and merchant bankers on behalf of the company.	Equity shares are tradable through a private broker or a brokerage house.
People who apply for these securities are: a) High networth individual b) Retail investors c) Employees d) Financial Institutions e) Mutual Fund Houses f) Banks	Securities that are traded are traded by the retail investors.
One time activity by the company.	Helps in mobilising the funds for the investors in the short run.

Structure of Financial System

Classification by Immediate delivery or Future Delivery

Cash or spot market: Where there is trading of financial instruments or commodities in a public financial market for immediate delivery, such a market is referred to as spot or cash market. This market is in contrast with the futures market where delivery is done in a later or future date. A major observation in the spot market is that settlement is due in $t+2$ working days. This implies that cash and commodity delivery must be carried out after two working days. It is always the case for spot market transaction to be conducted in an area where infrastructure is in existence.

Derivative market: A financial market which is derived from other asset forms is referred to as derivative market. Instruments like futures, options and contracts are the financial instrument offered in such a market. A derivative market is usually divided into two: the over-the-counter derivatives and the exchange-traded derivatives. Derivatives are used to diversify a portfolio or to manage risk. They are also used to speculate on market movements.

Foreign Exchange Markets

- Two types

- Spot market

- Immediate delivery.
 - Use of brokers and currency dealers.

- Derivatives market

- Futures
 - Forwards
 - Options
 - Swaps
 - Standardized derivative products trade in markets such as Eurex and CME, while non-standardized products are handled by large currency brokers/dealers.

Structure of Financial System

Classification by Organizational Structure

Auction market: This is a market situation where buyers and sellers enter competitive bids and offers respectively at the same time. The traded price of a stock is the highest price in which buyers are willing to part with and the lowest price that is acceptable to a seller beyond which he is not ready to sell.

Over the counter market: When stocks are traded through a network of dealers, the phrase "over-the-counter" is often used. This is in contrast to a centralized exchange. Other financial instruments and debt securities, like derivatives, often traded via a dealer network are also part of the over-the-counter market.

Intermediate market: A situation in which one or more financial institutions serve as intermediaries between counterparties in a transaction. For example, in the sale of a house, a bank usually intermediates the market by providing a mortgage to the homebuyer

Live County Auctions



Types of Equity Instruments

Ordinary/Common stock: The holders of this type of share are offered ownership interest in the company, as well as voting rights and probably dividends. Often, based on different number of votes per share. The shares are divided into different classes usually labelled as Classes A, B, and C. Payment of dividend is not guaranteed and may actually be put on hold in the event of the company struggling financially. In fact shareholders of common stocks are often the last to be paid in the event of the company undergoing liquidation. In order to take care of this risk, this class of shareholders are paid higher dividend yield than the rate paid to holders of preference shares.

Preference shares: the holders of this share are also given ownership right but not the voting rights. They are the second class of shareholders to be paid in the event of company liquidation; the first to be paid are bond holders. Shareholders can convert their shares to common stock if it is convertible. Shares that are callable give the company the choice of deciding when to carry out the conversion. Features of Equities: (i) Equity share capital stays on a permanent basis with the company. It can only be returned in the event of the company winding up. (ii) Holders of equity shares have the right to vote and elect the company's management. (iii) The amount of dividend paid on equity capital is a function of surplus funds availability as equity capital does not have a fixed rate of dividend.

	ORDINARY /EQUITY SHARES	PREFERENCE SHARES	DEBENTURES/ BONDS
<u>MATURITY</u>	<i>permanent capital Can't be redeemed</i>	<i>Irredeemable [no pay off] **</i>	<i>Redeemable ** [mature at a time]</i>
<u>CLAIM ON INCOME</u>	<i>'variable income security'...cannot legally force.....</i>	<i>Prior claim on income over equity shares **</i>	<i>legal obligation to pay income on due date</i>
<u>CLAIM ON ASSETS</u>	<i>Residual claim</i>	<i>No right in surplus assets</i>	<i>No share in surplus assets</i>
<u>CONTROL</u>	<i>Each equity share=1 vote</i>	<i>No voting rights</i>	<i>No control over management</i>
<u>CALL FEATURE</u>	<i>no</i> → [Entitles a company to redeem its securities before maturity]	<i>Yes [may buy back]</i>	<i>yes</i>
<u>OTHER FEATURES</u>	<p>➤ Limited liability Cannot be held for further lossesenjoys ownership without risks</p> <p>➤ Pre-emptive right →</p>	<p>➤ Hybrid form of security</p> <p>can issue right shares....shares must be offered to existing shareholders ..</p>	<p>➤ Creditors of the company</p>

Types of Preference Shares

Cumulative & Non-cumulative

Cumulative Preference Shares: Holders of these type of shares have a right to claim dividend for those years that the company did not make profit. Any moment the company makes profits; cumulative shareholders are paid, as of rights dividend for the previous years in which dividend was not declared.

For instance, a company may not be able to pay dividend to holders of preference shareholders for two years e.g. 2000 and 2001. If in 2002 the company makes enough profits, holders of cumulative preference shares will be first paid dividend for the years of 2000 and 2001 before 2002 dividend is declared. The dividend will continue to cumulate unless otherwise paid.

Non-Cumulative Preference Shares: There is no claim by the holders of these shares for dividend arrears. They are only paid a dividend in the event of availability of sufficient profits. They do not lay claim to arrears of dividend in subsequent years. The holders of these shares are not paid any omitted dividends. It denotes preferred stock shares whose dividend normally begins all over every year. In the event of the failure of the company to pay dividend in a particular year, arrears will not be accumulated for the dividend. It is only expected of the company to pay dividend for the current year before paying the remaining one to common stock holders.



Types of Preference Shares

- **Participating** – may, after receiving a preference dividend at a fixed rate, participate with ordinary shareholders in further profits distributed
- **Convertible** – right of conversion to ordinary shares
- **Redeemable** – ability to redeem shares for cash at a later date

Note that some have the characteristics of equity and others the characteristics of debt

Participating Preference Shares

The company's surplus profits are first paid at a fixed rate of dividend and later at a reasonable dividend rate on equity shares, to the holders of participating preference shares. If at the end of paying these dividends there is surplus profit, it will be open to preference shareholders. The criteria for sharing the surplus profits between equity shareholders and preference shareholders are provided in the article of association.

Redeemable Preference shares: it is usually given that a company's capital is repaid during the period of liquidation. The company is neither expected to return share capital nor the shareholders demanding repayment. It is however expected that the company can issue redeemable preference shares if it is permitted by the article of association. After a certain period, the company has the right to return redeemable preference share capital. Some restrictions have been made available by the Companies Act on returning the capital. The redeemed shares must be paid up fully and the company should either by out of profit or out of fresh issue of capital, redeemed these shares. The objective of this limitation is to ensure that company's resources are not depleted.

TYPES OF PREFERENCE SHARES

On the basis of
Convertibility

Convertible
Preference
Shares

Non-
Convertible
Preference
Shares

On the basis of
Redemption

Redeemable
Preference
Shares

Irredeemable
Preference
Shares

On the basis of
Right to arrears in
Dividend

Cumulative
Preference
Shares

Non-
cumulative
Preference
Shares

On the basis of
Further Rights
with respect to
Profits

Participating
Preference
Shares

Non-
Participating
Preference
Shares

Difference between Ordinary & Preferred share

Residual claimants: A common stock or share ensures that the interest of the owner in the company is provided and protected. The right to vote and possibly dividend payment is guaranteed. Based on the number of votes per share, common stock is often divided into classes. Payment of dividends is not guaranteed and could be put on hold in the event of the company passing through financial struggles. In the case of the company's liquidation, common stock holders are the last to be paid. This risk is often mitigated with higher dividend yield over the holders of preferred shares.

Voting right: There is the guarantee of ownership but no voting rights in the case of preferred stock holders. Traditionally, holders of preferred stock in the event of company liquidation are the second to be paid while the holders of bond are the first. In the case of convertible stock, the shareholder has the choice to convert the shares to common stock.

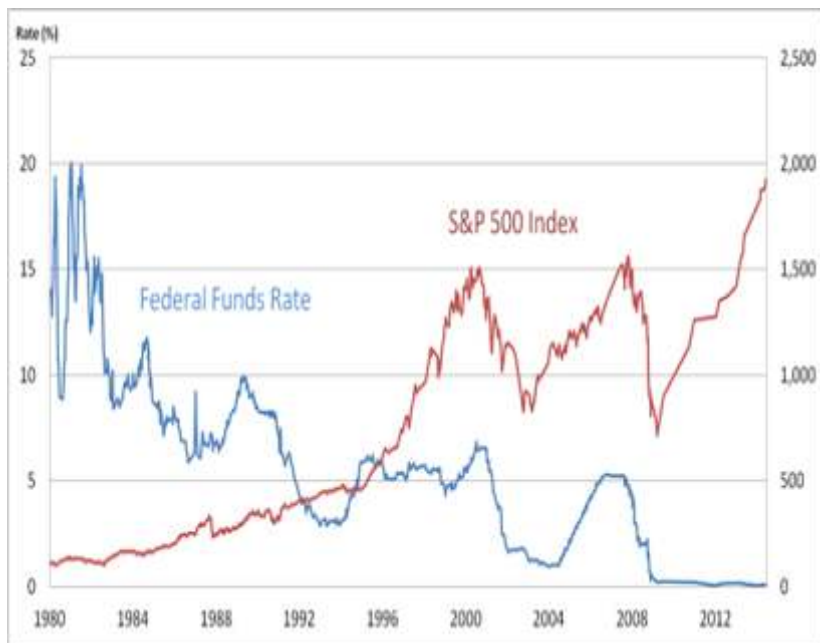
Ordinary shares, also known as common shares, have a lower priority for company assets and only receive dividends at the discretion of the corporation's management. Ordinary shares are generally entitled to one vote per share.

Aspect	Ordinary shares	Preference shares
Voting power	Carry a vote.	May not carry a vote.
Distribution of profits (dividends)	A dividend which may vary from one year to the next after the preference shareholders have received their dividend.	A fixed dividend (fixed percentage of nominal value) in priority to ordinary dividend.
Liquidation of the company	Entitled to surplus assets on liquidation after liabilities and preference shares have been paid.	Priority of repayment over ordinary shares but not usually entitled to surplus assets on liquidation.

Relationship between Equity Price and Interest Rates

Fundamentally, interest rate is the cost paid by an individual for using the money that belongs to another individual. This description is quite familiar to homeowners as they often use money from the bank, based on mortgage, in buying a home. When they get involved in this transaction they pay for the privilege of using funds from the bank. In addition, credit card users are also familiar with this since they borrow in the short term to buy whatever they need at the time. However, for the stock market, the interest rate and its impact is more than the above scenarios even though as we will see, the market is equally affected.

The rate of interest affecting investors is the monetary policy rate. This is the cost of borrowing money from the central bank like the Central Bank of Nigeria (CBN) for example, by banks. This rate is very important as the CBN uses it to attempt to control inflation. When too much money is chasing too few goods or when too much demand is chasing too little supply, we have a situation of inflation as prices will be forced to rise. The CBN influences the available supply of money for purchasing goods and thereby control inflation. The central banks of other countries also do the same to control inflation as well.



What is Debt/Bond Market?

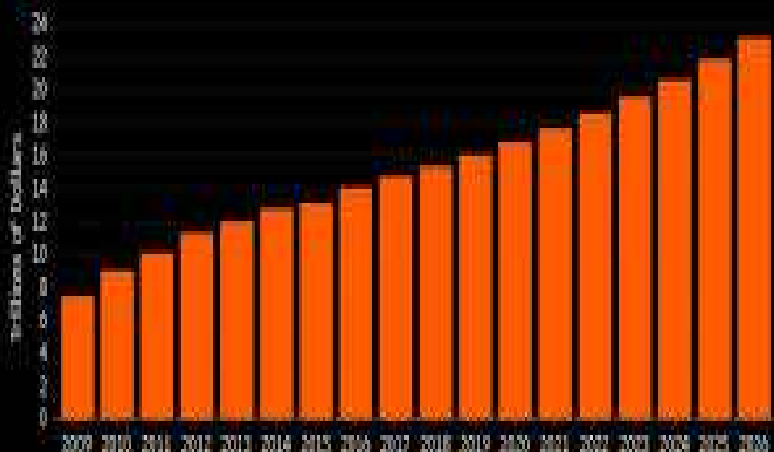
A financial market for issuing new debt by participants is known as debt market. It is also referred to as bond or credit market. When new debts are issued, the market is known as primary market, but the buying and selling of debt securities, is known as the secondary market. The secondary market is usually in the form of bonds, but it may include notes and bills. The primary goal of the secondary market is to provide long-term funding for private and public expenditures. The United States has dominated the global bond market, accounting for about 44 per cent.

Bond market is a component of the credit market, with the other component being bank loans. From the global perspective and size, the aggregate global credit market is about 3 times the size of global market for equity. In essence, bank loans as securities are not categorized under Securities and Exchange Act. However, bonds are usually and highly regulated by the Securities and Exchange Commission. Government bond market is an important component of the bond market based on its size and liquidity. It is often used in comparing other bonds in measuring credit risk. The bond market indicates changes in the rates of interest and the shape of the yield curve.

Debt Burden Set to Rise

U.S. will need to sell more bonds as spending needs grow

■ Debt Held by the Public



Source: Congressional Budget Office

Bloomberg B

Types of Debt Instruments

Bonds: A fixed-income security and a debt instrument created to raise capital for investment. It can also be described as a loan agreement between an investor and bond issuer whereby the issuer has the obligation of paying back at a specified future date a specified amount of money.

Mortgages: this is an instrument of debt which is secured by designated collateral of real estate property in which the borrower is obliged to pay back with a predetermined set of payments. Businesses and individuals used mortgages to purchase large real estate without necessarily paying the entire value of the purchase up front. The loan is repaid by the borrower over a period of many years, including interest, until he/she eventually becomes the owner of the property free and clear. The bank can foreclose the property if the borrower stops the payment of the mortgage.

Debentures: A debenture is a debt instrument that is not secured by collateral or physical assets but by trustworthiness.

TYPES OF DEBT INSTRUMENTS

There are many kinds of debt instruments among of them are as follow.

- ❖ Debenture.
- ❖ Bond
 - Government bond
 - Corporate bond
 - Convertible bond
- ❖ Loan
- ❖ Mortgages.

Features of Bonds

Redeemable or Irredeemable Bond:

This is a bond that can be redeemed by the issuer before the maturity date based on some conditions. The time it can be redeemed and the price of doing so, will be explained at the time of being issued. Quite often, its price is always slightly higher than the par value of the bond and will increase when the bond is earlier called. A bond will be called by a company if its payment of coupon is higher than current interest rates in the market. Essentially, at a lower rate of interest, same bonds can be reissued by the company and thereby ensuring that some amount are saved on all the coupon payments; this is a process that is referred to "refunding." However, bonds have been found to have highest prices under these circumstances, with the rate of interest decreasing right from when the bonds were issued, thereby increasing the prices.

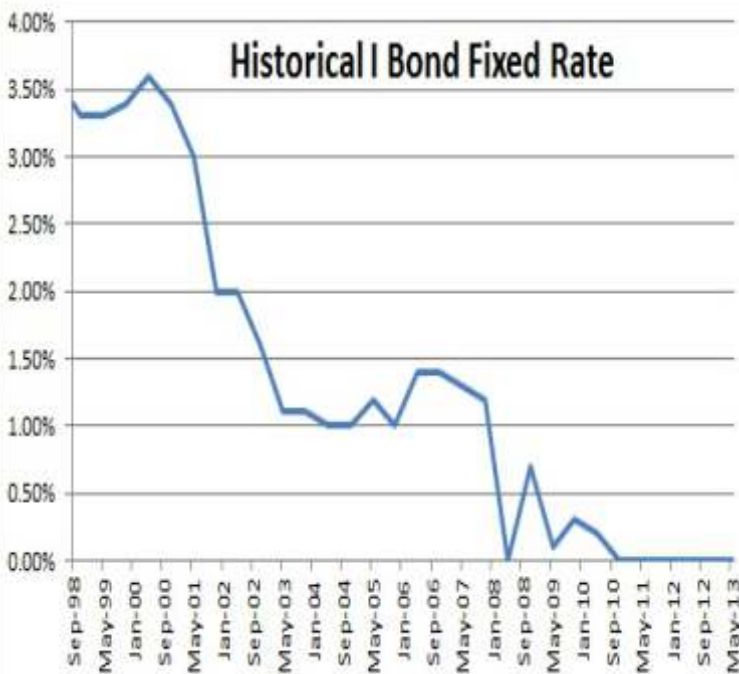
Irredeemable bond is a government bond without date of maturity but with a steady stream of interest. For example, a fixed income security perpetual bond without maturity date. A major disadvantage of these bond types is that they are irredeemable. With this disadvantage however, the benefit lies in its ability to pay a steady stream of interest forever..

Bond Term	Meaning
Issuer	Borrower
Investor	Lender or Creditor
Principal, Face Value, Par Value	Amount Borrowed
Coupon Rate	Interest Rate
Coupon	Interest Payment
Maturity	Due Date
Term	Time Until Maturity
Yield to Maturity	Annualized Return on Bond Investment
Market Value	Current Price

Fixed or Floating Interest Rate Bond

Fixed bond interest rate is a type of debt instrument where the coupon (interest) is fixed unlike the floating rate. Indeed, a bond with fixed rate is a long term debt paper whose rate of interest is predetermined. The rate of interest is called coupon rate with payable interest payable at dates specified earlier than bond maturity. As a result of the fixed coupon, the market value of a fixed-rate bond is susceptible to fluctuations in the rates of interest. Thus, there is embedded in it, a significant risk associated with the rate of interest. Having said so, the fixed-rate bond, is highly susceptible to a loss in value associated with inflation. The bond's fixed-rate with long schedule of maturity and predetermined coupon rate provides a solid return to an investor with the individual exposed to higher consumer price index and corresponding decline in purchasing power. Floating rate bonds offer some protection against rising interest rates because the interest rate on these bonds will be reset based on some standard measure of general interest rates. It's a good thing to read the fine print, though, as there is usually a tradeoff. These types of bonds are currently rare though they are sometimes issued by companies or municipalities with less than pristine credit ratings. The premier lenders do not have to offer this type of incentive to sell their bonds.

Historical I Bond Fixed Rate



Convertible or Non-convertible Bond

Those bonds which have the feature of being converted at a later date to equity shares are referred to as convertible bonds. The conversion can occur in two ways. At a predetermined price during the issuance of the bond and at prevailing market price. However, those bonds that cannot be converted are referred to as non-convertible bonds.

Convertible bonds are also called hybrid securities. This is because they carry features of both debt and equity. The investor receives interest periodically. On converting it to equity shares, he/she, just like a shareholder, also enjoys benefits. Thus, a bondholder enjoys both as a fixed income investor where coupon payments exist and also potentially benefit from any rise in the company's share price.

As a result of convertible bond having the additional option of converting to equity share, its rate of interest is often lower than non-convertible bond. However, after a specific period or specific date, there are bonds that are compulsorily converted into equity shares. These types of bonds are called compulsorily convertible bonds. Those other bonds that cannot be converted to equity shares are referred to as non-convertible bonds.



Key Features of a Bond

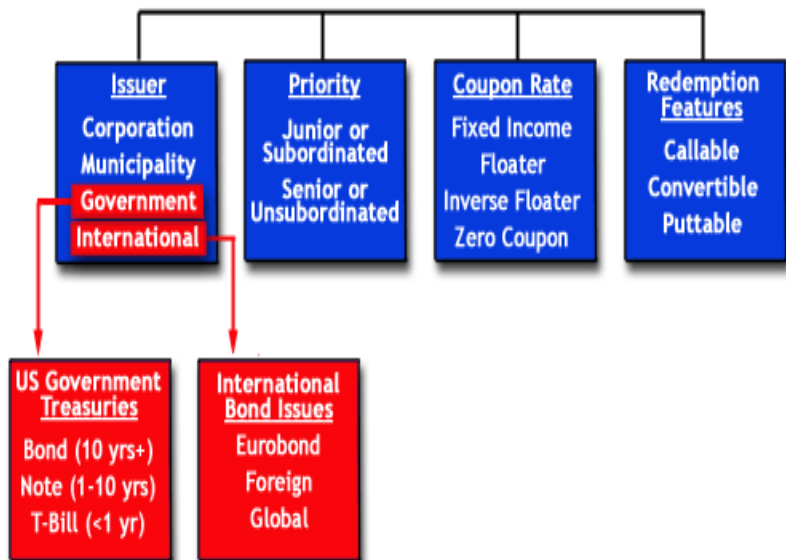
- Par value – face amount of the bond, which is paid at maturity (assume \$1,000).
- Coupon interest rate – stated interest rate (generally fixed) paid by the issuer. Multiply by par to get dollar payment of interest.
- Maturity date – years until the bond must be repaid.
- Issue date – when the bond was issued.
- Yield to maturity - rate of return earned on a bond held until maturity (also called the “promised yield”).

Secured or Unsecured

Generally, bonds are described as either being secured against assets or unsecured. Secured bonds are those ones that are backed by assets. When a company is wound up, secured bonds will be sold off against the asset of the bond and the investor will be repaid. When the bond issue is backed by reputation and creditworthiness of the issuer and not by any pledged asset, then the bonds are unsecured bonds.

A company's order of repaying its debts is a function of the ranking of the bonds in terms of maturity. In repaying its assets, the company abides by the following order in repaying the dues: Statutory and tax dues; Secured bonds (senior); Secured bonds (subordinated); Unsecured bonds; Preference shares and Equity. Secured bond exists when it is collateralized by an asset like, equipment which is the common practice for bonds issued by railroads, transportation companies and airlines, property or by income stream of another kind. When there are no specific assets but "full faith and credit" of the issuer, we have unsecured bonds. The investor only has the promise of the issuer to repay but no specific claim to any collateral

Bond Characteristics



Difference between Bond and Equity

Priority of repayments: As a bondholder and creditor to the organization, one enjoys a higher claim on assets and is accorded the priority of repayment before an equity shareholder. As a creditor, you have the major advantage of having a higher claim on assets than shareholders do. The primary advantage of being a creditor is that you have a higher claim on assets than shareholders do. For instance, if there is a case of bankruptcy, a bondholder is paid before a shareholder. The snag however is that bondholders do not partake in the company's profits if it does well as his/her entitlement is only on the principal plus interest.

Payments: Recall that bonds are actually long-term debt instruments whereby the issuing institution/corporation makes a promise to pay the principal amount at a precise date. On the other hand, owners of stocks are paid dividends only if the corporation declares profit.

Essentially, ownership interest in a corporation is represented by the stocks or shares. On its own, bonds are long-term debt whereby the issuing institution/corporation makes a promise to pay at a precise date the principal amount. Dividends are paid to stock owners by the corporation only when dividends are declared.

DIFFERENCE BETWEEN BONDS AND STOCKS



- Bonds and stocks are both securities, but the major difference between the two is that stockholders have an equity stake in the company (i.e., they are owners), whereas bondholders have a creditor stake in the company (i.e., they are lenders).

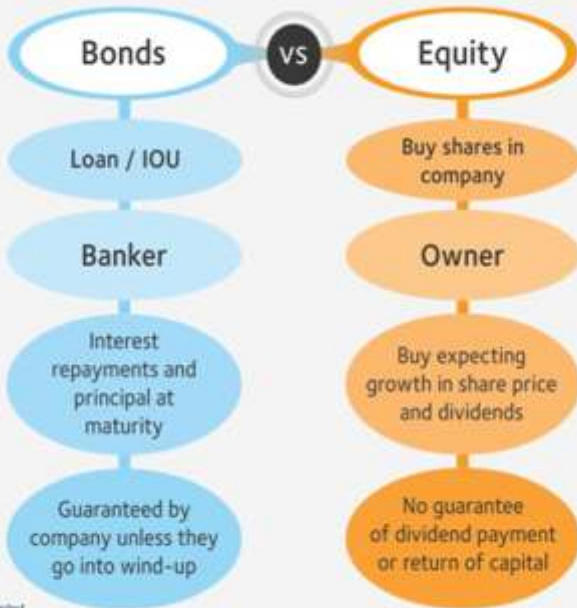
Difference between Bond and Equity

Capital appreciation: There are several reasons why bond prices can rise. Some of these include a fall in the rates of interest and improvement in the issuers' credit standing. Holding a bond to maturity does not result in the realization of any price gain over the bond's life. Rather, we see the bonds price reverting back to par at 100 on nearing maturity and principal repayment. When a bond is sold after a rise in price or before maturity, price appreciation, also called capital appreciation, can be realized by investors on the bond. Total returns increase as a result capturing capital appreciation on bonds and this combines income and capital appreciation.

Voting right: The purchase of a stock by an investor makes him an owner in the corporation. This ownership is also associated with voting rights and the right of sharing in any future profits. However, the purchase of debt (bonds) makes an investor a creditor to the institution/corporation (or government).

Guarantee periodic payments: A bondholder receives a periodic interest payment during the time between when the bond is issued and when it matures while a shareholder receives dividend from the profit made by the firm.

Stability: Apart from maintaining a diversified portfolio of investment, bond is more stable as equity is usually associated with volatility and fluctuations



Source:
FIG Securities Limited

Financial Intermediation

Financial intermediation is an act of collecting funds from depositors by financial lenders/institutions and then lending them to borrowers. That is, it is a process where the people with excess funds give banks or any other financial institution, and the bank offers credit to those individuals who require the funds for personal or business reasons. It often involves mobilizing the financial savings and channeling them to borrowers through specialized institutions known as banks. These specialized institutions are also called financial markets licensed to accept those deposits and lend them to the business and households at given interest rates over a specified period. This process provides the opportunity of maturity-risk match-making. Financial intermediation also cuts across making payments, receivables, transfers and guarantees by the banks on behalf of their customers. Examples of organizations that carry out financial intermediation are banks, insurance firm, leasing companies, micro-credit, private equity, venture capital, pension funds, amongst others. Some of these organizations enjoy a cost advantage in providing these intermediation services in such a way that they cannot only pay their bills but also make profits, thereby bring about efficiency in the general economy.

DIRECT FINANCE

Lenders/net savers

- Households
- Firms
- Government
- Non-residents

Funds

Financial markets

- Money market
- Capital markets

Funds

Borrowers/net spenders

- Firms
- Government
- Households
- Non-residents

Funds

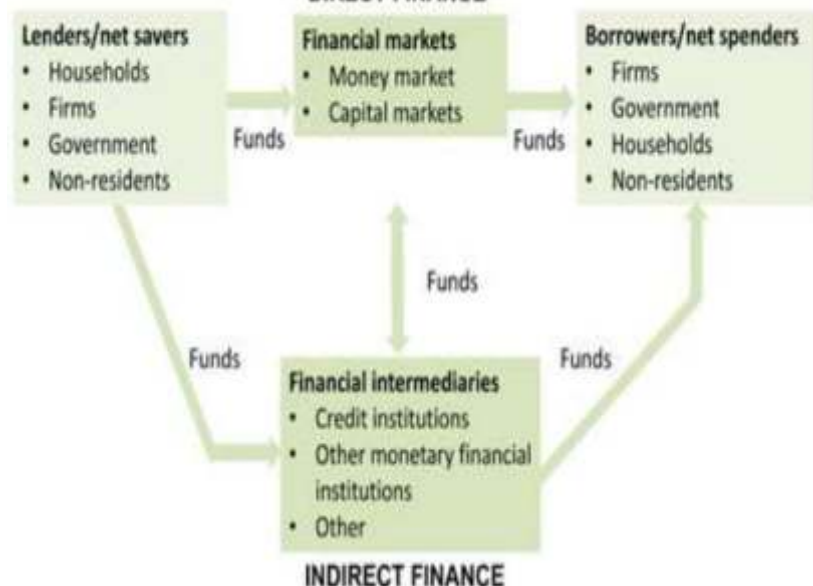
Funds

Financial intermediaries

- Credit institutions
- Other monetary financial institutions
- Other

Funds

INDIRECT FINANCE



Capital Formation

Capital formation may be summarily described as the process of increasing investment for the purpose of producing goods and services to grow the real economy. The process starts by mobilizing surplus funds from economic agents (Firms, Government and Household) and turning them to loanable funds that will eventually be used to acquire capital goods. It can be described in three different forms: (i) as concept used in macroeconomics and national accounts. It connotes a gauge of the net accumulations to the capital stock of a sector or country, or, a gauge of the quantity that total capital stock (physical) improved during a specified period. (ii) as a general expression for capital buildup, indicating the total "stock of capital" that has been accumulated over a period of time. (iii) in a wider view, it connotes national drive for savings, by establishing banks and other financial institutions, fiscal and monetary policies, formation and development of capital markets, public borrowing, privatization, amongst others. In this sense, it suggests any approach used to improve the mobilization and volume of capital for the primary goal of investment in the economy.

Capital Formation



Money Market

The Money Market is a portion of the financial market where short term highly liquid financial instruments are traded. The market provides a platform for borrowing and lending in the short term, for a specific period within a year. Money markets trading are commonly done in over-the-counter (OTC) and are in tranches. The instruments in the market are usually described as liquid given their ease in converting to cash, marketability and short tenors. Securities traded in the market include Treasury Bills (TBs), Bankers' Acceptances (BAs), negotiable Certificates of Deposit (CDs), and Commercial Paper (CP) among others. The fundamental area in money market comprises interbank activities, where financial institutions can lend and borrow to one another using several instruments such as repurchase agreements, commercial paper, amongst others. This market can be grouped into primary and secondary. The primary market is the market for the original investment or instruments and it involves new issues of securities to raise initial funds. The secondary market is for trading in the investments or instruments that have already been dealt with on the primary market.



Money Markets Instruments

Treasury Bills

It refers to short-term negotiable debt instruments or securities issued by the Federal Government of Nigeria for various tenors not exceeding 364 days. In other words, it is government debt instruments issued by the Country's Treasury Department to finance the national debt. Treasury bills do not come with an interest rate attached to them; instead, they are sold through competitive bidding, and they pay face value at maturity. The holder's return, therefore, is the difference between the price paid and the face value. Interests are earned up-front because they are discountable instrument. They are issued mainly to borrow money from the public to execute Federal Government obligations and sometimes to reduce excess liquidity. Nigerian Treasury Bills (NTBs) show the relationship between yield and maturity on Nigeria's treasury bills differing only in term to maturity. Treasury securities are broadly classified into marketable and non-marketable treasury securities. Examples of marketable treasury securities are Treasury bills, Treasury bonds, Treasury notes and Treasury Inflation Protected Securities (TIPS). They are very liquid and are heavily traded on the secondary market. Those treasury securities that are Non-marketable have several types such as; Sub-regional Government (e.g. State and Local) Series, Government Account Series debt issued to government-managed trust funds, and savings bonds. They are allotted to subscribers and are not easily

FEDERAL GOVERNMENT OF NIGERIA

No

TREASURY BILL
(TREASURY BILLS ORDINANCE, 1958.)

No

Due

£1000

LAGOS,

19

This Treasury Bill *entitles*
SPECIMEN *or Order*

to Payment of One Thousand Pounds *at the*
Central Bank of Nigeria, Lagos

on the day of 19

GENERAL MANAGER

SECRETARY

CENTRAL BANK OF NIGERIA

* IF THIS BLANK BE NOT FILLED IN, THE BILL WILL BE PAID TO BEARER.

Treasury Certificates and Term Money

Treasury Certificates

It is a short-term loan from the Central Bank of Nigeria to Federal Government of Nigeria where there is a need to borrow money. In other words, it is largely a non-marketable treasury security issued to the public with a short maturity, typically three months but not more than a calendar year. They are usually issued once or twice monthly with interest rates that are odd (e.g. 7.233% and 9.131%) and offered at par. An example of a treasury certificate is the Central Bank of Nigeria lending N1 billion to the Federal Government of Nigeria for twelve months. It signifies an obligation of the Federal government represented by certificates in denominations ranging from N1 million to N1 billion maturing in one year or less with interest periodically payable by the redemption of coupons. Term money products are short term financing instruments used by banks with fixed maturity typically 30, 60, 90, 180 or 360 days. They offer a longer duration than call money and earn interest rates higher than call money.

Confederate Treasury Certificates

A Collector's Guide to IDRs



**Interim Depository Receipts
of the Confederate States of America**

George B. Tremmel • Pierre Fricke • John Martin Davis, Jr.

Commercial Papers/Bills

It is a money-market instrument that is often offered by big companies for funds to meet short term debt obligations. It is commonly collateralised solely by an issuing company or financial institution with an agreement to pay the face value on the date of maturity stated on the bill. It is largely unsecured, short-term debt instruments that a corporation or other private organization uses to ensure it has adequate cash on hand to cover operating costs. In view of the fact that it is not supported by collateral, only corporations with exceptional ratings from reputable credit rating organizations will have capacity to offer their notes at good rates. It is commonly offered at a markdown from face value, and normally tendered interest rates that is lesser than shorter maturities bonds. Normally, the lengthier the maturity on a bill, the greater the interest repayment the issuing company offers. These rates oscillate with prevailing conditions in the market, but are usually less than financial institutions' rates. In sum, it is a trading bill (bill of exchange) offered by a corporation, that is recognized by a financial institution (or a bank), unlike Treasury bills that are offered by the government.

ALBERT, N. W.
MATTIE W. BENDER
TRON

Call Money

It is an exceptionally short-term financial institution loan that must be repaid on demand and does not contain regular principal and interest payments. As opposed to term loan that has fixed maturity and repayment arrangement, call money needs not follow a stereotyped arrangement. It is regularly operated by brokerage companies to fund margin transactions. Brokerages utilise call money as a short-term funding source to shield margin transactions. They are however, unguaranteed, recallable credits that are often more riskier than other credit lines. For example, a brokerage firm XYZ wants to acquire many stocks of Firm123 for a customer. The customer does not have money immediately and requires margin loans which will be repaid in 21 days. The Broker may decide to borrow call money from a financial institution and then use the funds to purchase the stocks. The financial institution may decide not to establish a repayment arrangement for the Broker given that the Broker has promised to repay the loan on time. However, financial institutions can recall the credit at any time and fix the call money rate at NIBOR + 0.10%. If the financial institution decides to recall the credit before the 21 days expires, the broker may release a margin call to its customer, thereby demanding the customer to pay the loan immediately.



Call
Money

Certificates of Deposits

A certificate of deposit (CD) is a fixed deposit, instrument commonly offered by financial institutions, such as banks, credit thrifts and unions. CDs are analogous to savings deposits in that they are protected "money in the bank" and thus virtually risk free. In Nigeria, it is insured by Nigerian Deposit Insurance Corporation (NDIC). CDs are different from savings deposits, as the CD has a fixed term that is specific, (say one, three, or six months, or one to five years) and, typically with a set interest rate. The financial institution may require the client to hold the instrument till maturity, when the client may decide to withdraw the fund with accumulated interest. In return of the client placing the fund for an agreed period, banks may offer greater interest rates compare to accounts where clients can withdraw on request. Fixed interest rates are normal, but some banks grant CDs with menu of flexible rates. Occasionally, banks may present CDs that are indexed to the capital market, or any other types of indices.

CERTIFICATES OF DEPOSIT (CDs)

Maximum security with a guaranteed rate of return



Bankers' Acceptance

Banker's acceptance (BA) is a future promissory note that is recognized and guaranteed by financial institutions and drawn on a deposit at the institution. BA stipulates the person to whom the payment is due, the amount of the fund and the date. Once the acceptance is done by the financial institution, the draft develops into an unconditional liability of the financial institution. However, the bill-holder can discount the draft for immediate cash, while the new holder may need to wait till the maturity of the fund. BA commonly begins as the time a draft is drawn on a financial institution's deposit by a bank's customer to pay at a later date, say within six months. Afterward, the financial institution accepts and guarantees payment to the draft holder. This is equivalent to a postdated cheque drawn on a deposit with overdraft safeguard. It makes a financial transaction among parties who may not be familiar with each other safer, since they allow the parties to substitute the financial institution's credit worthiness for that of the individual owing. Banker's acceptances are typically sold in multiples of millions of Naira and those that are smaller than the agreed multiple is referred to as odd lots.

No. _____

192 _____

(CITY OF DRAWER)

(DATE)

ON _____

(DATE OF MATURITY)

PAY TO THE ORDER OF OURSELVES

DOLLARS (\$ _____)

THE OBLIGATION OF THE ACCEPTOR HEREOF ARISES OUT OF THE PURCHASE OF GOODS FROM THE
DRAWER. THE DRAWEE MAY ACCEPT THIS BILL PAYABLE AT ANY BANK, BANKER OR TRUST COMPANY IN
THE UNITED STATES WHICH SUCH DRAWEE MAY DESIGNATE.

ACCEPTED

(NAME OF BANK)

(CITY OF DRAWER)

(SIGNATURE OF DRAWER)

BY _____

TO _____

(NAME OF DRAWER)

PAYABLE AT _____

DATE _____

LOCATION OF BANK _____

(STREET ADDRESS)

(SIGNATURE OF DRAWER)

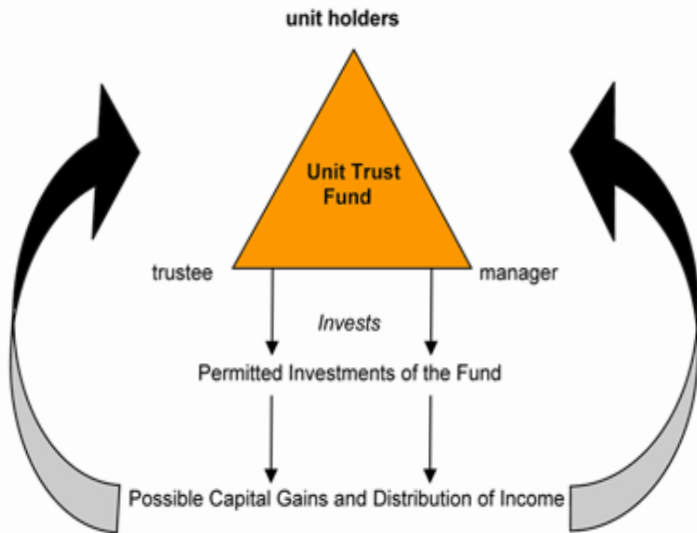
(CITY OF DRAWER)

BY _____

Unit Trust Funds

A unit trust fund is a pooled resource, which allows a group of investors to combine their cash and invest it. It is an arrangement of mutual investment established under a trust deed. It offers opportunities to a wider-range of securities investments. They are open-ended investments; connoting that there is no-finite number of units issued and it can decrease or increase depending on the net sales and repurchase by existing unit-holders. This is unlike investment trusts. The Units Trust is administered within what is called "Managers Box". The Fund manager commonly makes evaluations at each assessment period to review the portfolio, either by adding or reducing units. This review is usually based on the final net sales and exchanges before the next review period where the Unit Trust is priced on a "Forward Basis". Alternatively, the Unit Trust is priced based on the actual review period. The most common form is the forward pricing. Each Unit Trust has a stated investment objective that will govern the goals and limitations of its management

Concept Of Unit Trusts



Open Buy Back (OBB)

Open Buy Back (OBB) refers to discountable securities that are acceptable for trading in the Nigerian inter-bank financial market. It is essentially used for raising short-term capital and also offers borrowers the benefits of using treasury bills as a liquid asset. The most common form of security used for the OBB is the Nigerian Treasury Bill. It involves the transfer of the borrower's bills holding to the lender's bills portfolio at the Central Bank and in turn, transfers of the worth of the bills from the lender's account to that of the borrower. An OBB is similar to a Repo in the sense that both of them consist of the transfer of money for security with an arrangement to buy back. However, while a Repo has a prearranged repurchase date, the OBB transaction is flexible and securities transacted may at no time be repurchased earlier than maturity. Secondly while a Repo can be traded with various types of securities, OBB is mainly restricted to Nigerian Government allotted securities.



Liquidity Adjustment Facility

Liquidity adjustment facility is a form of monetary policy tool that allows banks to borrow money from the central bank through the use of repos, standing lending facility (SLF) or discount windows. A repurchase agreement (repo) is a type of collateralized short-term borrowing backed typically with government debt securities. It is an agreement to sell a debt instrument such as government Treasury bill with a promise to repurchase the security at a higher rate and at a specified future date. It is called a repo for the seller of the security, while it is a reverse repurchase agreement (reverse repo) for the buyer of the security. Repos and reverse repos are typically used to raise short-term funds. Generally, liquidity adjustment facility is effective in aiding banks resolve short term liquidity mismatches and thus reduce liquidity pressures in the banking system thus ensuring stability in the system and the economy. The central bank of Nigeria also uses the Standing Lending Facility (SLF) in adjudging the health of the banking system. Persistent use of the SLF window by banks is a red flag and may indicate pending distress in the banking system.

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graph TD; A[Liquidity Adjustment Facility (LAF)] --> B[Repo Rate]; A --> C[Reverse Repo Rate]
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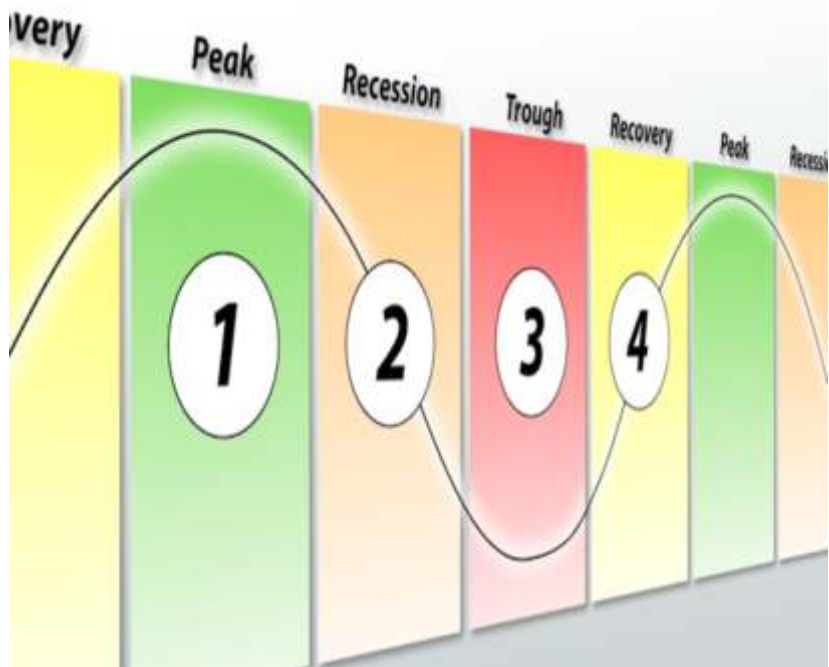
**Liquidity
Adjustment Facility
(LAF)**

Repo Rate

**Reverse
Repo Rate**

Stabilization Securities

Stabilization securities are issued with the objective of providing the central bank with a stock of securities with which it can intervene in the market for managing liquidity. These securities are issued not to meet the government's day to day expenditure but to enable government provide tangible assets for the country. In other words, they are debt instruments aimed at maintaining macroeconomic stability. It is usually part of the macroeconomic strategy enacted by governments and central banks to stabilize the economy. This may include examining the business cycle and modifying standard interest rates to influence aggregate demand in the economy. The aim is to circumvent unpredictable changes in aggregate output, as gauged by the gross domestic product (GDP) and huge variations in the general price level. Attainment of equilibrium in these factors mostly brings about reasonable changes in the general employment level as well.



Ways and Means Advances

Ways and means advances (WMA) is a system operated by central banks as part of its credit policy in which it offers to governments and the banking system a credit facility to help them overcome transient disparities in the cash flow of their revenues and expenditures. Repayment usually may not exceed one quarter (i.e. three months) from the date of providing the credit facility. Two forms of WMA are prominent – normal and special WMA. The Normal WMA is clean credits, while Special WMA is secured credits offered against the collateral of government securities. The operational threshold for special WMA for a regional government is dependent on its holdings of federal government tenured-securities up to a limit officially approved. Hence, the central bank ascertained the maximums for special and normal WMA for each regional government as multiples of the recommended lowest balance needed to be reserved with the central bank by that regional government. These boundaries can be amended when necessary.



Nigeria Stock Exchange (NSE)

The Nigerian Stock Exchange (NSE) is a trading platform where stocks (also called shares), bonds, and other securities are bought and sold in Nigeria. The Exchange provides amenities for the issuance and redemption of securities and other financial instruments, and capital occurrences such as the payment of dividends and other incomes. Examples of instruments traded on a typical stock exchange include shares issued by listed companies, pooled investment products, unit trusts, derivatives, and bonds. The Nigerian Stock Exchange provides a trading platform for stocks, bonds and other securities for the biggest economy in the continent of Africa. The Exchange is an incorporated organisation that is limited by guarantee. It was established in 1960 and licensed under the Investments and Securities Act (ISA). It is regulated in Nigeria by the Securities and Exchange Commission (SEC). Some of the services carried out by the Exchange include licensing of stockbrokers, listing and trading of securities, providing adequate stock data for proper market analysis, ancillary technology services amongst others.



The Capital Market and its Role

The capital market is the segment of the financial market where medium to longer-term instruments (generally those with original maturity of more than one year) are created and/or traded to meet the long-term funding needs of economic activities. The role of the capital market in the economy includes its contribution to speedy economy growth and development through enhancing production and productivity in the national economy. The capital market provides the necessary vehicle required for the mobilization of idle savings for productive activities in the economy. Domestic firms source medium to long-term funding for productive use from the capital market. The market is an important source for capital formation through the mobilization of ideal resources which are channeled into effective long term investments. Investments in the capital market also serve as effective hedge against inflation and currency depreciation. The capital market is central to a well-functioning economy, since capital is crucial for generating economic output.



Primary vs Secondary Markets

Capital markets are further segmented into primary and secondary markets. The main function of the primary market is to facilitate the efficient allocations of funds. The primary market is concerned with the raising of new funds or where new shares are bought and sold, while the secondary market is a market for trading in existing securities that are already in people's hands thus, enabling savers who purchased securities when they had surplus funds to recover their money when they need cash. The primary market will however not function effectively without a well-organized and efficient secondary market. The existence of secondary markets enhances demand for initial public offers (IPO) in the primary market. Thus, the main function of the secondary market is to make it easier and quicker to sell financial instruments to raise cash; that is, they make the shares, bonds and other instruments more liquid. The primary and secondary markets are inter-related and inter-dependent.

Capital
Market



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graph LR; A[Capital Market] --> B[Primary Market]; A --> C[Secondary Market]
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The diagram consists of three rounded rectangular boxes. On the left is a green box containing the text 'Capital Market'. To its right are two blue boxes, one above the other, containing the text 'Primary Market' and 'Secondary Market' respectively. Two blue lines originate from the right side of the green box and branch out to connect to the left side of each of the two blue boxes, forming a 'V' shape.

Primary Market

Secondary
Market

Participants/Operators of the Capital Markets

Participants in the capital market consist mainly of the firms and individuals who have surplus funds and those who have a deficit of funds to undertake economic activities. It is thus a market for investors and those who seek to finance their deficit positions. The participants in the capital market can be categorized into four, namely: Providers of Funds - this includes individual and institutional investors, unit trust, Nigeria Social Insurance Trust Funds (NSITF), insurance companies and other corporate bodies; Users of funds - this includes government and companies/corporations for their long-term investment; intermediaries - This includes stock brokering firms, issuing houses and registrars; and the Nigerian Stock Exchange (NSE) - The NSE provides the platform, information and the rules and regulations needed to ensure orderly and smooth operations of the exchange.

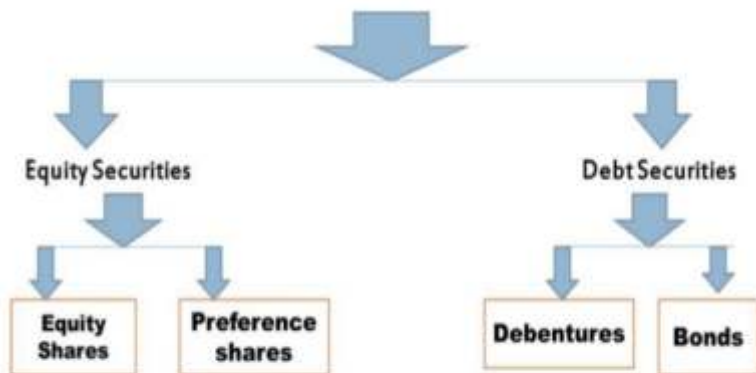


Instruments Traded in the Capital Market

Capital market instruments are typically corporate securities that may be either debt, equity or derivative securities used to raise money for long-term purposes as opposed to money market instruments which are traded short-term debt instruments. The instruments/products traded in the capital market have wider fluctuations than money market instruments and are considered to be relatively risky investments.

The major instruments used to raise funds in the Nigeria capital market include: Equities (ordinary and preference share); Government bonds (federal, states, and local government); and Industrial loans stocks (debenture, preference share and corporate bonds). Others include Unsecured zero coupons, mortgage loans, Unit trust scheme, Unquoted or unlisted securities. The instruments traded in the capital market depends mainly on the debt and level of development of the stock exchange.

BASIC CAPITAL MARKET INSTRUMENTS



Primary Market

The primary market is an aspect of capital market that involves issuing of new securities by corporate organizations or governments in order to raise funds. In this market, interested members of the public acquire these securities without intermediaries from issuers, which could be corporate organization, in case of initial public offer/private placement, or from the central government for treasury bills and bonds. This is often done through an investment bank or consortium of securities dealers. There are several methods of raising or floating new issues in the primary market to the public. These include: New Issues - New issues are securities raised in the primary market for the first time; Initial Public Offer (IPO) - When a (unlisted) company makes a public issue for the first time and gets its shares listed on stock; Offers for Subscription - Offers for subscription is an invitation by a company inviting the public to subscribe to new shares; Offer for Sale; where, existing shareholders offer their shareholding or part thereof for public subscription; and Private placement: where the securities are placed with broker/issuing house who then seeks to prospective purchasers or sell them to his clients instead of being offered directly to the general public.

Classification of Capital Marketing



Secondary Market

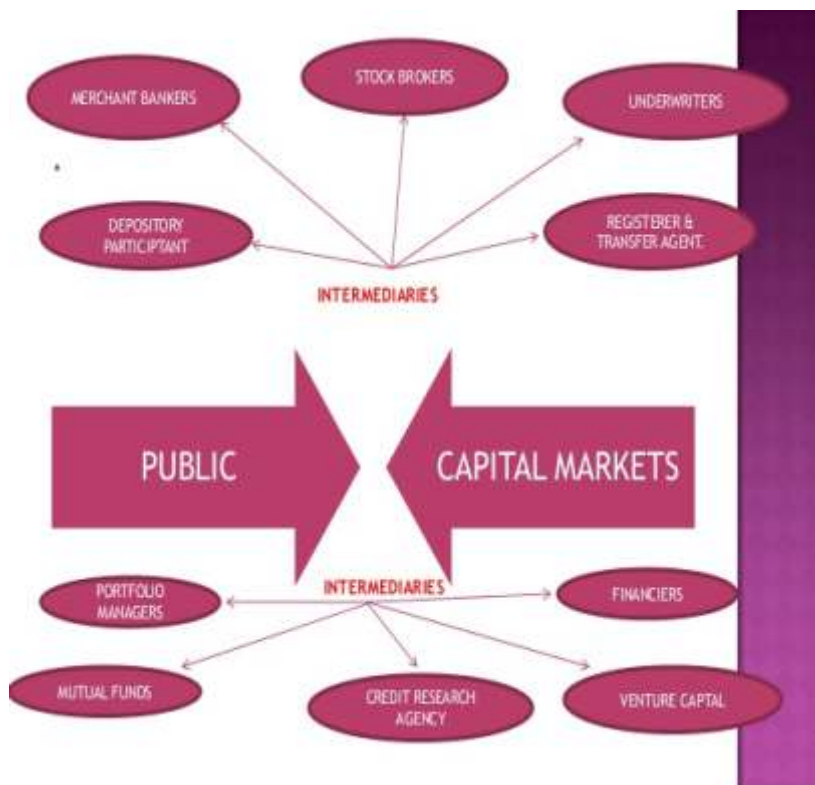
This is an aspect of the financial market where hitherto allotted financial instruments such as shares, bonds, derivatives, including futures and options are bought and sold. The best-known examples of secondary markets are New York and American Stock Exchange. In the case of Nigeria, it is the Nigerian Stock Exchange (NSE) and Abuja Commodity Exchange (ACE). The secondary market can be further segmented into two; namely organized market and over-the –counter market (OTC). The organized market is where buyers and sellers (or their agents or brokers) meet in one central location to conduct trades e.g. NSE and ACE. In the case of Nigeria, the market for equities in the NSE consists of two tiers, namely, the first tier and second tier exchanges. The first-tier deals with issues of quoted companies while second-tier introduced largely to accommodate the features of SME (Small and Medium Enterprises) which find it difficult to fulfill the stringent listing requirements in the first-tier market. On the other hand, the OTC market has no centralized mechanism or facility for trading, instead trading occurs over sophisticated telecommunication network. The market is conducted through dealers.

Secondary Market



Capital Market Intermediaries

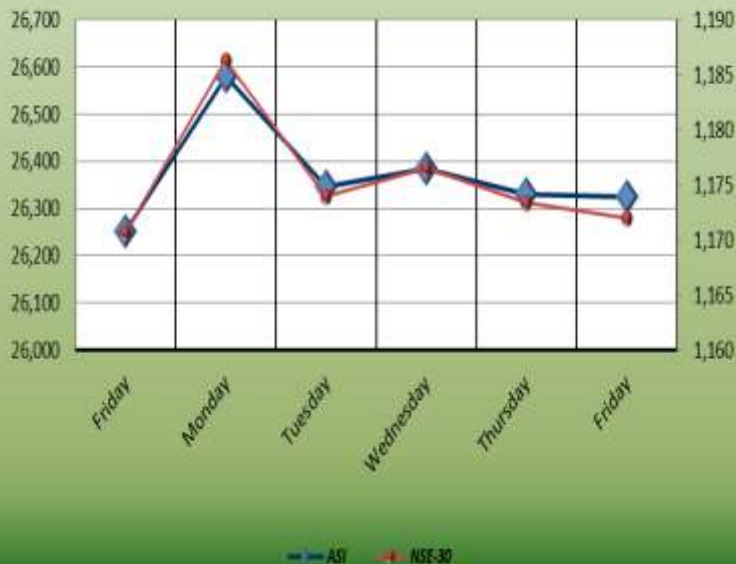
Capital market intermediaries include stock brokering Firms that are licensed by the stock exchange, with obligation of upholding a fair and orderly sequence of prices for a particular security transacted on the Exchange. In effect, it is an intermediary. Another intermediary are Issuing houses which are corporate organisations and non-dealing members of the NSE that organize prospectus to sell new securities offered to the member of the public by issuers such as incorporated firms and governments; The Registrars which are institutions in the capital market that keeps the records in respect of quoted stocks and shares in the market. Registrars usually referred to as transfer agents are concerned with the issue of opening registers and keeping the list of share/stock of the firms after the close of subscription and allotment.



Capital Market Indicators

Capital market indicators are computed by analyst to assess the performance of the market over time. The All-Share Index (ASI) is a statistical measure used in evaluating the changes in capitalization from one period to another usually benchmark against a base period. Market capitalization (MC) is the aggregate value of all the stocks listed in the stock market. Market turnover measures the total value of transactions done on the NSE during a specified period. Price-earnings ratio of a company's current share price compared to its per-share earnings. Warren Buffett Valuation Metric is the total MC to GDP. It is one of the commonly used metric to determine if the stock market is trading too high or too low relative to the domestic economy. Yield curve is a graph that shows yield on bonds with different terms to maturity, but the same credit risks, liquidity and tax consideration.

The NSE All-Share and NSE-30 Indices
Week Ended January 13th, 2017



Similarities and Differences between Money and Capital Markets

Similarities: There are several similarities between money and capital markets. First, both money and capital markets are key components of the financial system. Second, both markets allow investors to buy debt securities, which are financial products that an investor purchases and the issuer promises to pay back, such as bonds.

Differences: On the other hand, a line of demarcation between the money and capital markets can usually be drawn based on the maturity/term-frame of the security traded. In the Money market, generally, short-term debt instruments with maturity of less than a year, are trade while capital markets trade on long-term debt instruments with maturity greater than one year. Thus, money market instrument are more liquid than capital market instruments (degree of liquidity). The rate of return in the money market is often low but steady due to lower risk and short-term when compared to the capital market. This implies investors take more risk on the capital market than the money market.



Money Market vs. Capital Market

Similarities and Differences between Money and Capital Markets

Degree of Liquidity: The instruments traded on the money market are highly liquid, stable and pay competitive rates because of its short-term tenor while capital market instruments traded in the capital market are less liquid because they have a long- term horizon of more than 1 year.

Rate of Return: Money market returns are often low but steady because it tends to have lower level of risk and short term. In addition, assets prices are stable and competitively priced. On the contrary, investments in the capital market tend to have a higher level of risk, they also generally offer a higher rate of return. This is a common dichotomy in the investment world.

Level of Risk: The instruments traded in the money market are less risky. The markets offer safer assets, because the instruments offer small fluctuation in price, making them safer heaven for investors. On the hand, the instruments traded in the capital market have high risk, essentially stocks/equity where future prices and dividends are highly uncertain.



Money Market vs. Capital Market

Regulators of the Capital Markets

The regulation of the capital market is undertaken by the following institutions: Security and Exchange Commission (SEC), which is the apex regulatory authority in the Nigerian Capital Market. SEC is a Federal government Agency and it was founded by No. 71 of SEC Act of 1979. It evolved from the Capital Issues Committee (CIC). The Nigeria Stock Exchange (NSE): The NSE is an organized secondary market for buying and selling of securities. It is a market where those who wish to buy or sell shares, stocks, government bonds, debenture, and other approved securities trade. The CBN is a major participant in the Nigerian capital market. It is the apex regulatory institution for both banks and non-bank financial institutions in Nigeria. Similarly, it also underwrites central government debts offered, by taking all unsubscribed portions of the debt.

Capital Markets



Regulators of the Capital Markets

Security and Exchange Commission (SEC): SEC is the apex regulatory authority in the Capital Market. It is a Central government Agency founded by No. 71 SEC Act of 1979. It evolved from the Capital Issues Committee (CIC).

The Nigeria Stock Exchange (NSE): The NSE is an organized secondary market for buying and selling of securities. It is a market where those who wish to buy or sell shares, stocks, government bonds, debenture, and other approved securities.

Central Bank of Nigeria (CBN): As with money market, the CBN is a key participant in the capital market. Primarily, it is the apex regulatory institution in both banks and non-banks financial institutions. It also underwrites federal government debt, by taking all unsubscribed portion of the debt.

The Chartered Institute of Stockbrokers (CIS): The Chartered Institute of Stockbrokers (CIS) is a non-profit making organization chartered by the Act 105 of 1992. The main function of the CIS is to regulate the conduct and practice of the stockbroking profession in Nigeria



CAPITAL MARKET

Cash /Spot Market Vs. Derivatives Markets

What is Cash or Spot Market?

Cash market, also referred to as spot market or physical market. Is an open-type financial market where different financial instruments or commodities are traded. In a spot or cash market, financial commodities are sold, bought and delivered immediately or within a range of few days, usually not exceeding one month, depending on the existing local terms of transactions or regulations. The price quoted for the sale or purchase of commodities in a cash or spot market is known as the spot price. A typical example of commodities traded in spot or cash market is crude oil. A spot market can take place through-an exchange-where financial products are traded on an exchange using current market price and over the counter (OTC) – where transactions are open and carried out between two parties under mutually agreed contract terms that may not be subject to any standard or exchange guidelines.

Spot Market



Payment



Immediate Delivery

Warrants Market

Warrant market is a system where warrants are issued and purchased by investors. Warrants are financial securities issued by a corporation with a view to raising capital, which gives the holder of the warrant the right to purchase shares in the company at a specified price, and on a specified future date.

Warrants market can be either primary or secondary. In the primary segment of the warrant market, the investor is not obliged to transact through a broker, rather warrants can be purchased directly from a warrant issuer. On the other hand, a secondary warrant market involves a listed exchange where warrants are traded by authorized dealers.

**WARRANTS
MARKET**



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graph TD; A([WARRANTS MARKET]) --- B([PRIMARY WARRANTS MARKET]); A --- C([SECONDARY WARRANT MARKET]); B --> C
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The diagram illustrates the structure of the Warrants Market. It consists of three main components: a central yellow oval at the top labeled 'WARRANTS MARKET', a red oval at the bottom left labeled 'PRIMARY WARRANTS MARKET', and a blue oval at the bottom right labeled 'SECONDARY WARRANT MARKET'. A large orange arrow points from the Primary Warrants Market to the Secondary Warrants Market, indicating a flow or relationship between these two segments.

**PRIMARY
WARRANTS
MARKET**

**SECONDAR
Y
WARRANT
S
MARKET**

Derivatives Market

What is Derivatives Market?

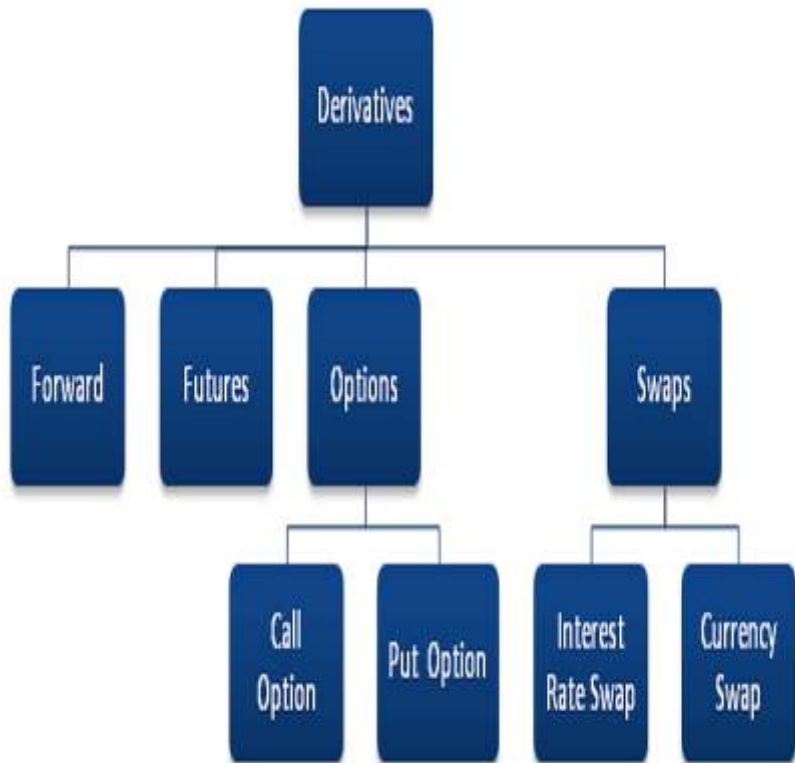
Derivative is a contractual agreement between two or more partners, where financial instruments are traded. Thus, the financial instruments traded in a derivative contract are called derivatives and the system where the trading takes place is called derivatives market. The values and prices of the financial instruments traded are derived from, and determined by fluctuations of one or more underlying assets. Derivatives cannot exist on their own as they derive their values from underlying assets. The underlying assets which derivatives derive their values differ in characteristics. For example, some derivatives are derived from underlying debt and shares instruments, while some are derived from commodities. There are however some derivatives whose values are derived from neither debt, shares, or commodity instruments, known as weather derivative. The most common underlying assets include currencies, stocks, bonds, market indices, commodities, and interest rates.

DERIVATIVE



Types of Derivatives

Derivatives are characterized by 4 different types of contracts; Forward Futures, Contract Options, Contract, Swap Contract. Forward Contract is a financial contract or an agreement undertaken by two entities to trade financial instrument on a pre-agreed future date, and at a pre-agreed price. Forward contracts are generally traded only in an over the counter (OTC) market and not through an exchange market. A futures contract is a financial agreement undertaken by two entities, to trade financial instruments at an agreed price, and at a pre-determined future date. Futures contracts are different from forward contracts as futures contracts are standardized and transacted via an exchange, while forward contracts are non-standardized, and transacted over the counter. An option is a type of contract undertaken by two different entities or parties, where one of the parties provides the other party the right to buy or sell to the first party, an underlying asset at a mutually agreed price, on an agreed specific future date.



Types of Options

There are two types of options contract; call option and put option. Call option is a type of option contract where the person buying the instrument is given the right without the obligation to procure an underlying asset of an instrument. Due to the possibility of an increase in the price of an underlying asset, the buyer in an option contract purchases only the right to buy at a specific price but not the obligation by paying the premium to the seller. Put option is a contract where the option holder is given the right to sell an underlying asset, and not the obligation. The holder of a put option pays a premium for not purchasing the obligation to sell at the maturity of the contract. If there is an increase in the monetary value (price) of the underlying asset as at the date of maturity of a put contract, the seller may not sell as this may result in a loss for the seller. Equity option is another type of contract where the buyer is given the right without the obligation to procure or sell another instrument being the underlying asset based on equity securities.



Swaps

Swaps are financial contracts or agreements where two parties mutually agree to exchange cash flows or different currencies at a pre-agreed rate and a future date. Swaps contracts can serve as hedging instruments for certain risks such as interest rate risk. Swaps are also used as speculative tools for expected changes in the movements of underlying asset values or prices. There are two main types of swaps; interest Rate Swaps and currency swaps. Interest rate swaps contract occurs when two parties agree to swap only interest related cash flows of the same currency between the parties. Currencies swap is a contract where both the principal and the interest of a currency transaction are swapped between two parties, while the cash flows are in one direction and in a different currency. It is a foreign exchange derivative that is also referred to as cross currency between two foreign institutions wherein the principal and /or interest of the loan payment in one currency is made in another currency at an equivalent value.



Rights

Rights are legal principles of entitlement, privilege or freedom to perform an action or make use of an element. Rights also connote fundamental normative laws or rules guiding an entity or something. They are principles which illustrate what is acceptable in a system. In financial terms, right is the legal entitlement, freedom, or privilege to have access to financial applications, products, instruments or services. Rights are contents of financial system that are considered fundamental for driving financial systems processes effectively. An example of rights is the privilege obliged shareholders of a company to subscribe to new common stock before the public offer. Rights in the financial system are exchanged independently in a trade of an underlying instrument – stock on an exchange. The monetary value (price) of a right is influenced by certain factors which include the price of the underlying instrument (stock), its subscription value or price, interest rates and expiration time. The value of a right instrument as at the time of the rights contract, differs from the value of a rights instrument at the expiration of the rights contract.



Mortgage-Backed Securities (MBS)

A mortgage-backed security is a type of asset-backed instrument that is backed by a mortgage or collection of mortgages. An MBS can also mean mortgage pass-through or mortgage related security when, the interest and the principal payments by the buyer or borrower pass through mortgage-based security, or in a more complex situation, the pass through will be via a pool of other MBSs. This type of security can be traded through a broker. The mortgage backing the MBS, must originate from a regulated and authorized financial institution. The MBS mortgages can be commercial or residential. Example of MBS is Mortgage Backed Bonds (MBS Bond), being a type of bond backed by a basket of mortgage loans. Individual mortgages are pooled together and used as collateral to issue mortgage-backed securities, which are then sold to investors. The key difference between MBS and a regular bond (which typically pays interest every six months), is that the MBS monthly payments include a portion of principal.

- Financial Institutions sell mortgages to the MBS Trust

The mortgage payments go to the MBS Trust

Mortgage-Backed Securies Trust

- The Trust uses the money received from MBS Bond Investors to purchase individual mortgages.

- The MBS Trust sells bonds to investors.
- The investor receives the mortgage payments - principal and interest.

Investors Buy MBS Bonds secured by mortgages (MBS)

Asset-Backed Securities (ABS)

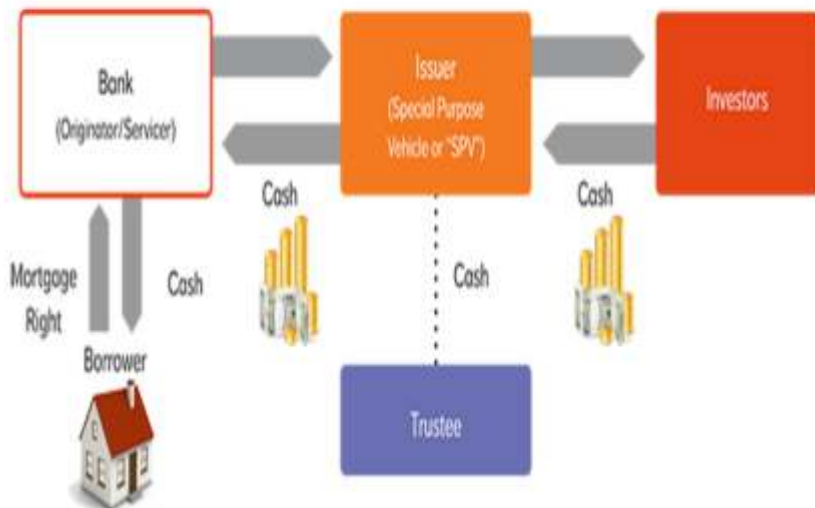
Asset-backed securities (ABS) are financial instruments backed by mortgage loans, auto loans, credit card debt, royalties, or companies' receivables. It is similar to a mortgage-backed loan except that mortgage-backed securities are secured by mortgage or a pool of mortgages, while an asset-backed security is secured by a pool of small and illiquid assets which are not sold individually. Asset-backed securities are different due to the diversification elements wherein fractions of the aggregate value of the diverse pool of underlying assets allow diversification of the associated investment risks. Asset-backed securities provide the issuers avenues to raise extra cash, which is used for additional lending while providing investors the chance to invest in a wide variety of income-generating assets. Normally, the underlying assets of an ABS are illiquid and are difficult to be sold independently. However assets can be gathered together to create financial security, which enable the owner to create a market for them.



Mortgage Loans
(incl. Mortgage Right)



Bonds



Exchange Traded Funds (ETF) or Commodities

Exchange Traded Funds or commodities are investments in physical commodities related to a specific economy which are traded on stock exchanges. Such commodities include items like agricultural products, precious metals and natural resources. ETFs are characterized by features such as tax efficiency, low costs, and stock like features. Exchange traded funds are financial investment secured by asset-backed contracts where the performance of a basket of commodities or a single commodity is tracked. The shares of ETFs are exchanged in kind with a basket of underlying authorities. The structure of ETF differs across countries. In some countries, they are operated as discretionary trusts that are subjected to the status of ETF, while in some countries; they are operated by ordinary companies. ETFs are referred to as 'long only' funds which means that they may only invest the funds of the investors and not engage in 'shorting' the market, that is selling the securities not owned, and borrowing them in order to deliver. Price changes occur throughout the day in exchange traded funds.



Central Banking

Central banking is an act of providing financial and banking services by the Apex bank for the government and its commercial banking system, in addition to implementing the government's financial policy and delivering legal tender currency. Central Banking is carried out by the Central Bank. An institution that manages a country's currency, the level of money supply in the country and interest rate. Such as the Monetary Policy Rate (MPR) as the case of Nigeria which stand at 14% from the second quarter of 2016 to date.

The establishment of the bank of England was seen as the origin of central banking, even though it does not have the peculiarities of the modern central banks. Such as: to be the lender of last resort, to be the distributor of Bank notes, to be the regulator of the value of a Nation's currency and to act as Banker to the Government.

It has authority over all other financial institutions in promoting financial stability and a sound financial system. Its traditional role is the regulation of the stock of money in order to promote social welfare.

Overview of central banking



Central Banking

Definition of a Central Bank

A central bank is a national institution that conducts monetary policy, regulates banks and acts as lender of last resort. It is an institution charged with the responsibility of regulating the supply, availability and the cost of money in the interest of social welfare.

A central bank acts as banker to the government; raises money for the government; as well as maintains the nation's currency reserves. Its goals include: ensure monetary and price stability; promote sound and safe financial system among others.

It is a regulatory bank with full autonomy in providing financial and banking services for its Government and commercial Banking system.

It supervises and regulates the activities of the nation's commercial banks. The importance and relevance of the central bank in any society cannot be overemphasized as it is difficult for any country today to exist without a central bank. The powers, constellation of functions, broad orientation and techniques of central banks differ from one country to the other.

Manage the Nation's Money

Regulate Banks

Stabilize Prices



Differences Between Central Bank And Commercial Bank

CENTRAL BANK

One of the primary function of the central bank is, they to facilitate the wellbeing and economic development of a country and is owned by the government.

- They Issue legal tender currency and control the supply of money in the economy.
- They accept deposits from other (commercial) banks.
- They act as custodian of country's foreign exchange
- They control credit creations in the economy, thus acting as a clearing house of other banks.
- The central bank also exercises its control over financial institutions by wielding its two weapons of bank rate and open market operations

COMMERCIAL BANK

- The commercial banks are owned by either the state or private institutions.
- They accept deposits directly from customers
- They are also being regulated and supervised by the central bank.
- They grant loans to customers (Households, Firms and Governments).



FirstBank
Since 1894



United Bank for Africa



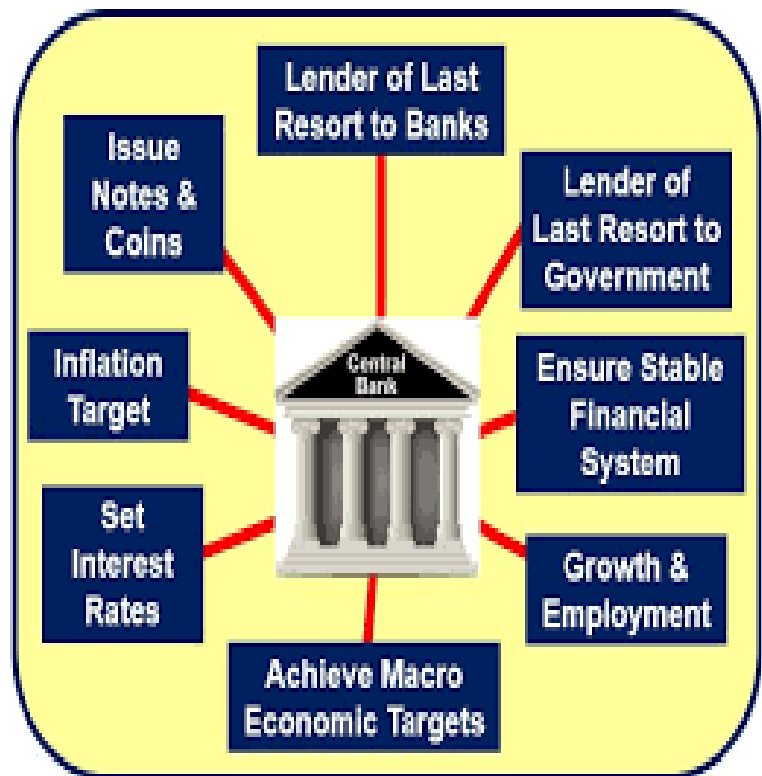
FCMB



The Role of CBN in the Financial System

The primary function of the Central Bank of Nigeria is "Price Stability", maintenance of the country's foreign reserve so as to ensure the international value of the domestic currency, issuing of legal currency notes and maintenance of a sound financial system. As a monetary authority, the CBN performs other functions in the financial system such as; A principal regulator and supervisor of the financial system; Ensure stable and safe financial system; Enhance monetary and price stability and Lender of last resort to the banks.

In order to achieve its objectives, the Central Bank of Nigeria undertakes a number of functions as stated in the Act setting it up. These roles could be categorized as (a) traditional (here, the Central Bank of Nigeria acts as the banker to other banks and financial institutions especially in the areas of cheque clearing and being the lender of last resort. (b) Regulatory functions (the central bank regulatory functions focused at promoting and maintaining monetary and price stability in the economy. In the performance of the regulatory functions, the Central Bank of Nigeria formulates policies aimed at controlling the volume of money in circulation, and commercial banks and other key players in the financial system. They also regulate the extent to which banks can grant credits.



The Balance Sheet of the CBN

The central bank balance sheet is a monthly statement of assets and liabilities which represents the unaudited financial result and processes of the Bank at the end of each month.

The Assets side shows the overall External Reserves (together with Gold Bars), Government and other Securities, Loans and Advances, Fixed Assets and Other Assets.

The Liabilities in contrast shows the Capital that is subscribed and Paid Up, Currency in Circulation (CIC), General Reserve, Deposits which comes from Governments, Banks and others and other liabilities. In most countries today, a central bank or other regulator of financial system is charged with the issuance of the country's currency. This is because the supply of money greatly influences interest and inflation rates and, aggregate output. If the central bank's monetary policy is good, and creates just the right amount of money, the economy will bustle, and interest and inflation rates will be low. If it creates too much money too quickly, prices will increase speedily and wipe out people's savings. Therefore, the money supply is resolute on four groups: first, the central bank, commercial banks, depositors, and borrowers.

Balance sheet of central bank capable of both quantitative and qualitative easing

Assets	Liabilities
T: Treasury securities (purchased outright)	M ₀ : Monetary base (currency and commercial bank reserves held with the central bank)
L(T) Loans to the private sector secured against Treasury securities (incl. repos of T)	
L(P): Loans to the private sector secured against private securities (Incl. repos of P).	N: Non-monetary liabilities of the central bank (central bank bills and bonds)
P: Private Securities (purchased outright)	
X: Central bank foreign exchange reserves	
	W

CBN as Banker to Government

One of the roles performed by the Central Bank of Nigeria is “to act as Banker to Government” and it does this by maintaining the central account of the federal state governments.

The CBN maintains the nation's foreign currency reserves and liaises with international financial organizations on behalf of the government.

In its role as a banker to the government, the central bank deposits accounts, effects domestic and foreign currency transaction on behave of the government. Just as individuals hold deposit accounts with commercial banks, the government holds accounts with the CBN. The working relationship between the central bank and the government vary widely among different countries. The relationship can take one of three possible forms. First, is the case of complete and full independence of the central bank. Under this, the bank can pursue any kind of monetary policy that it deems fit without government interference. The second is a situation whereby the central bank is just another arm of the government. Here, the central bank takes directives from the government. The third is a case of equally inadvisable.



CBN as Banker to other Banks

The Central Bank maintains the cash reserves of the commercial banks which they keep as deposit. All commercial banks maintain deposits with the central bank.

This accounts held by the central bank are used in settling of interbank transactions as well as maintaining their cash reserves. The Central Bank together with the Commercial Banks is required to open a clearing house for cheques. This is to enable settlements of transactions.

It also acts as guardian and lender of last resort to the other banks. The central bank also acts as banker to commercial banks by providing services to the banking system similar to those which the commercial banking system performs for individuals and business enterprises. Some of the services rendered by the central bank including lend its role as the manager of the monetary system. Such services include the holding of legal reserves and acting as lender of last resort. It also provides services that promote the smooth working of the monetary system. Among such services may be the clearing and collection of cheques, distribution of coins and paper currency to commercial banks and supervising and regulating the activities of commercial banks. The CBN also ensures that the external transactions of banks are being carried out in fashions that are in conformity with internationally accepted standards.



FirstBank
Since 1894

UBA

United Bank for Africa



Diamond
Your Bank

FCME



Skye Bank



Keystone Bank
Ascent
Serving the community

CBN as Lender of Last Resort

A lender of last resort is an institute that makes credit or loans available to other banks.

The CBN provides advances to the commercial banks in financial difficulties.

The CBN does this in order to prevent banking system collapse. They provide help to other banks in the time of crisis and build confidence in the financial system.

The central bank provides money to the commercial banks experiencing crisis when they have no other means to raise funds. That is, if they cannot obtain finance from market sources. There are several situations in which a central bank could provide reserve money (and other forms of liquidity) to the banking system. The Central Bank of Nigeria provide reserve money to financial markets through open market operations (OMOs) as part of monetary policy implementation if the market has an ex ante shortage of reserve money; or to facilitate functioning of the payment system e.g., intra-day loans or a credit standing lending facility (SLF). the CBN can also respond to the increased aggregate demand for reserve money, foreign exchange (FX), or liquid assets, resulting from a market shock when normal market functioning is interrupted. They also provide financial help to other banks in an event of bank run.

Lender of Last Resort



Central Bank and Money Supply

A nation's money supply is determined by the monetary policy actions taken by its central bank.

Money supply denotes the total value of money in the economy and it comprises of currency (notes and coins) and deposit with Commercial Banks (Deposit Money Banks). There are basically two types of money supply in Nigeria; namely narrow money M1 and broad money M2.

M1 measure of money supply comprises currency outside banks and demand deposit (current accounts) at the banks and the CBN, while M2 includes M1, savings, time and foreign currency deposits. The component of savings, time and external currency deposits are also called quasi-money. M2 measure of money supply comprises of the total liquidity in the economy. When the levels of money supply by the CBN changes, it changes through the control of the base money. The Base money includes currency and coins outside the banking system and the deposits of commercial banks held by the central bank. If the central bank observes that prices are rising and there is too much money in circulation, it may reduce the base money by decreasing money supply. To reduce the base money, the CBN sells financial securities to banks and the non-bank public so as to reduce the money creation ability of commercial banks.



Objectives of Credit Control

Credit control is the regulation of credit (which is made available to the economy) by the monetary authority in order to achieve its set out objectives. Some of the objectives are; (a) Maintaining internal price stability, (b) Maintaining a stable exchange rate, (c) Maintaining the financial requirements of the government especially during crisis, (d) Promotion of rapid economic growth, (e) maintaining stability in the money market and Achievement of internal external balance. The wide objective of credit control policy is (a) To ensure an appropriate level of liquidity enough to attain high economic growth rate together with exploitation of resource devoid of generating high inflationary pressure, (b) Attainment of effective stability in the money market and exchange rate of the country (c) Achieving the financial requirement in period of downturn in the economy and during normal times as well as regulating business cycle and ensuring that business needs are met. According to Burgess, one of the main purposes of credit control is the "adjustment of the volume of credit to the volume of business." Credit is required in order to meet the need of trade and industry. As business develops, more credit is required, and when a business diminishes less credit is needed. Hence, by controlling credit, the CBN can meet the desires of business at any particular point in time.



Methods of Credit Control

Credit control in an economy is amongst the most important functions of the central bank of Nigeria. One important objective of controlling credit is to stabilize the price level in the country. Changes in prices adversely affect the economy. Thus, there is need to prevent inflationary or deflationary tendencies. There are broadly two methods through which the central bank controls credit namely, Quantitative and Qualitative measures.

Under the quantitative or general method, the central bank controls credit using; Bank Rate Policy: it is the rate at which the central bank rediscounts its first class securities. Bank rate is the official minimum rate at which the central bank of the country is ready to rediscount appropriate bills of exchange or lend on official securities. This rate can also mean discount rate. The qualitative method looks at the manner of channelizing of cash and credit in the economy. It is selective in nature as it restricts credit for certain sections where as expands for the other known as the 'priority sector' depending on the situation.

Methods of credit control

(1) Qualitative Method

1. Marginal Requirement
2. Rationing of credit
3. Publicity
4. Direct Action
5. Moral Suasion

(2) Quantitative Method

1. Bank Rate
2. Open Market Operations
3. Repo Rates and Reverse Repo Rates
4. Cash Reserve Ratio
5. Statutory Liquidity Ratio
6. Deployment of Credit

CBN and Monetary Policy

The conduct of monetary policy is one of the mandates of the Central Bank of Nigeria. The legal authority to conduct monetary policy by the CBN is derived from its Act of 1958 as amended in 1991 and the 2007 Acts.

The CBN undertakes monetary policy in order to: Maintain Nigeria's external reserve, Promote a sound financial system in Nigeria and Promote price and monetary stability. The monetary policy framework practiced during the early years of the Bank was exchange rate targeting, consistent with the paradigm at that time, such that the Nigerian currency was fixed at par, first with the British pound and, subsequently, with a basket of 12 currencies. This experiment led to a considerable measure of stability in the naira exchange rate and in monetary aggregates and prices, although there was credible evidence that the domestic currency was overvalued against the US Dollar. However, following the collapse of the "Bretton Woods system of the fixed exchange rate regime in the 1970s", the CBN adopted monetary targeting as a policy framework for the conduct of its monetary policy from, 1974 to date.

ROLES & RESPONSIBILITIES

MONETARY POLICY

Promoting A Healthy Economy



Commercial Banking

Commercial banking is the act of rendering financial intermediation services to the economy (household, firms and businesses and government).

It brings together people with surplus funds and those in need of these funds. It serves as the meeting point for lenders and borrowers of money. Commercial banks are the main operators in the Nigerian financial system and act as agents for mobilization and allocation of resources. It plays a dynamic role in stimulating investment and channeling of such investment to the different sectors of the economy. The Nigerian banking system has undergone significant changes over the years, in relation to the number of institutions, ownership structure, as well as complexity and extensiveness of operations. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of regulatory requirements that conform to international standards. Between 2004 till March 2017, there were 23 commercial banks in Nigeria.



Evolution and Growth of Commercial Banking in Nigeria

Commercial banking in Nigeria is dates back to 1892 with the formation of African Banking Corporation Ledger Depositor and Co. formed by a shipping company that was based in Liverpool. It was later taken over in 1984 by Standard Bank now "First Bank of Nigeria". This was followed by the establishment of Barclay's bank and company (Now union bank of Nigeria Plc) the bank was set up to provide banking services to the colonial administration in West Africa and for the British commercial interest. The West African currency board (Gyasi central bank) was set up in 1912 with the Bank of British being the agent of the currency board.

The Nigeria commercial bank is divided into two categories; Indigenous banks (100% owned by Nigerians) and Mixed bank (with 60% owned by Nigerians).

Commercial banking has grown over the past years. With about 24 licensed banks in Nigeria.

The establishment of commercial banks has encouraged savings and intermediary activities in the financial system.

This was not so until the establishment of banks in 1892.



Functions of Commercial Banks

Commercial banks carry out the following primary functions: Acceptance of deposit from customers; Granting of loans and overdraft (ability to withdraw more than you have in your account) to customers, Transfer of customers fund on instructions; Educational loan schemes; Provision of foreign exchange facilities; Financing SME's; Housing finance, etc.

The secondary functions performed by commercial banks are; overdraft facility (it's a facility that allows customers to overdraw his current account up to an agreed limit. Discounting bills of exchange (it is a facility that allows holders of a bill of exchange to get bills discounted with the bank before maturity. Also, the banks provide an Agency function that is performed by commercial banks with some commission. (Some of these agencies are; transfer of funds, collection and payment of various items, purchase and sale of foreign exchange, purchase and sale of securities, income tax consultancy, trustee and executor, letters of reference etc.) Commercial banks also perform some general utility functions such as (locker facility, traveler's cheques, letter of credit etc.)



Balance Sheet of a Commercial Bank

The balance sheet of a commercial bank is a financial statement that shows its assets and liabilities at a given period, usually one year. On the Assets side we have things that the bank owns, while liabilities are things that a bank owes to other people or other banks. A bank's balance sheet is different from that of a company's balance sheet, as it does not contain accounts receivable, accounts payable or inventory. Rather, under assets, what we have is loans and investments, and on the liabilities side, there are deposits and borrowings.

The assets components are shown on the right hand side while the liabilities components are shown on the left hand side.

The balance sheet of a commercial bank is an account that provides the image of its functioning.

The asset of a bank constitutes those items through which it receives income or profit. Where as the liabilities of a commercial bank are claims on it. Both the asset and liability sides should be equal. What makes them equal is the convention that the bank's capital is listed on the liabilities side, not the assets side of the balance sheet. The fact that capital is listed on the liabilities side of the balance sheet is convenient, not just because it makes the liabilities and asset sides equal, but also because it separates the uses and sources of funds.

Balance Sheet

As at 31 December 2005

Notes

16

18
20

2000

2011

2007
1

2006

2005 2006

2004

2005

2007

2006

2005

Role of Commercial Banks in a Developing Country

Commercial Banks play an important role in the economic growth and development of a country. They gather the idle savings of the people and make them available for investment. Also, in the process of granting loans and purchasing investment securities they create new demand deposits. Facilitation of trade both inside and outside the country is part of their role as they accept and discount bills of exchange. Banks also increase the mobility of capital. The banks can also support capital formation, control speculation; maintain a balance between requirements and availabilities and direct physical resources into desired channels. They play an active role in the economic development of a country, if the banking system in a country is disciplined, effective, and efficient; then it will bring about rapid growth in the various sectors of the economy. The roles played by the commercial bank in a developing country are as follows: Credit creation, Mobilization of savings for capital formation; Financing of industry; Financing of consumer activities, financing employment generating activities; Financing of trade and agriculture and Finance international trade.

Main Functions of Commercial Banks

Payments

- Traditional Options (Cheques, DD)
- Modern (Wire transfers, ECS)

Financial Intermediation

- Take deposits
- Lend
- Address safety and liquidity, growth needs

Financial Services

- Forex
- Wealth Mgmt
- Insurance
- Investment Banking

Merchant Banking

A Merchant Bank is defined as a bank that provides capital to companies in the form of share capital instead of loan. Merchant Banks traditionally, were banks that engage in trade financing. It is also seen as a type of institution that provides services such as;

Underwriting of shares portfolio management and Providing financial advisory services etc. Merchant banks, like commercial banks engage in funds intermediation. Merchant banks also perform wholesale banking while commercial banks specialize in retail banking.

A merchant bank can also be seen as a wholesale bank whose deposits are usually in large sums with a minimum of N10, 000.00. Such deposits are fixed for a particular period; and, they earn interest. With such large deposits its loans are equally of large denominations. The history of merchant banking dates from 1960, when Philip Hill (Nigeria) limited was established to carry out merchant banking in Nigeria. It was to dominate the scene for the next decade. In 1969, the Merchant Banking Activity of Philip Hill were transferred to Nigerian Acceptances Ltd. This institution was to dominate merchant banking until 1973 when new ones began to appear in the field.



MERCHANT Banking

Development of Merchant Banks

The banking reform of 2000 that brought about Universal Banking System led to the discontinuation of the activities of Merchant banks.

Merchant banking activities were conducted by the Deposit Money Banks as one stop shop, until the 2009 banking reform that reviewed the UBS which classified banks and evolved merchant banks again.

In 2010, CBN issued the guidelines for the licensing, regulations and operations of merchant banks.

Under this regulation, merchant banks are required to have a minimum paid-up share capital (minimum capital base) of N15 billion and not allowed to accept cash deposits except they are beyond N100 million. With the liberalization of the financial markets in the 1980s, the number of merchant banks grew steadily from 12 in 1986 to 54 in 1992. Between the year 1994 and 1998, the number of merchant banks dropped to 38. The declining trend of merchant banks activities continued in 1999 and 2000. This was due to the change in status of some key merchant banks to commercial banking in 1999 and 2000. Currently, there are 6 operational merchant banks in Nigeria as at March 2017.

Merchant banks and commercial banks provide complementary rather than competitive services; and in some areas (e.g. the provision of credit facilities for external trade) their activities overlap



RAMP
MERCHANT
BANK

A division of FirstRand Bank Limited

Traditional values. Innovative ideas.

Functions of Merchant Banking

The functions of merchant banks can be broken down into four; such as

(a). Banking services (merchant banks provide short-term finance by means of acceptance of credit for the finance of external trade. While such facilities are normally made available for a period of up to three months, they can be offered on a revolving basis)

(b). Financial advice to companies.

(c). Investment management services etc. The merchant bank also plays other functions like; a. Promoter of industrial enterprises.

(d). Credit syndication.

(e). Portfolio management.

(f). Leasing and financing (g) Servicing issues.

Merchant Banking

```
graph TD; MB[Merchant Banking] --> BS[Banking Services]; MB --> CS[Consultancy Services]; BS --> BS_desc[It helps businessmen to start a business and helps to raise (collect) finance.]; CS --> CS_desc[It provides consultancy to its clients for financial, marketing, managerial and legal matters.]; BS --- Plus[+]; Plus --- CS;
```

Banking Services

It helps businessmen to start a business and helps to raise (collect) finance.

+

Consultancy Services

It provides consultancy to its clients for financial, marketing, managerial and legal matters.

Merchant Banking act as Financial Engineer for a Business.

Development Banks

These are specialized financial institutions that provide long-term finance to support the growth and development of small, and medium enterprises.

These banks are established by the government to provide funds at affordable interest rates. They are established to provide all types of financial assistance such as medium and long term loans to businesses, underwriting etc. Development banks were established in Nigeria to fill the gap created by the inability of Deposit Money Banks to provide sufficient long term credit to prioritized sectors of the economy. Some of these sectors such as agriculture, manufacturing, mining etc require long term and medium term credit which are not readily available at affordable rates for investors. Commercial banks consider these sectors as highly risky to extend credit for their financing. Government therefore intervenes in such sectors by providing subsidized loans at flexible conditions in order to boost the contribution of these sectors to economic growth. Another reason for banks' inability to extend long term credit to these sectors is the short term structure of funds available to them which does not suit the long term structure of loans required for their financing.



Meaning of Development Banking

It is an institution established to work out incentive and regulations which would effectively induce private institutions to carry her obligations deserving priority. It is an institution established to work out incentive and regulations which would effectively induce private institutions to carry her obligations deserving priority. Development bank do not accept deposit from the public.

This is a structure created by the government to help in the allocation of funds or financial resources to the key sectors of the economy. This would aid in economic development as the bank is development oriented.

Development banks do not accept deposits from the public unlike commercial banks. It also aims at promoting savings and investment habit in an economy as well as providing loans for capital projects. In addition to providing loans for capital projects, some development banks also offer technical services and advice to their clients in order to enhance the growth of their businesses. There are 5 major development banks that are currently operational in Nigeria. These include: "The Bank of Industry, Bank of Agriculture, Nigeria Export-Import Bank, Federal Mortgage Bank of Nigeria and the Infrastructure Bank of Nigeria".



Community Development Banks

Community development banks are financial institutions that offer financial services and credit to under-served markets or population of a country.

According to Ugwuanyi, W. (2001), community development banks were introduced in Nigeria due to the problem of credit extension to the rural dwellers, who usually dominate the population and cannot afford the much-sought collateral being demanded by formal financial Institutions.

Prior to 1990, the low income groups in the rural economy were unable to benefit from the services provided by the traditional banking system. The services of the existing banks were mainly accessible to big and corporate customers and higher and middle income groups in the urban centers. The people's Bank of Nigeria which was formed in 1989 was only able to meet the needs of the people at the state capitals while their rural branches of commercial banks preferred rich rural dwellers and their urban counterparts. In order to promote rural development and enhance economic development at the grassroots level, the federal government announced, in 1990 Budget, a programme for the establishment of community banks To be owned and managed by community development associations, town unions etc.



Regional Development Banks

It is a financial institution established for the purpose of providing long term investment capital for industry (SME's) in an economy.

To qualify for a RDB loan, a company does not have to use pre-existing assets for collateral; instead the project becomes a collateral and the bank partners with the borrower to monitor successful project execution and loan repayment

The regional development banks (RDBs) are jointly owned financial institutions that aim at providing technical and financial assistance for development in the rural areas of low- and middle-income countries.

The Finance for this banks are allocated through low-interest loans and grants for a range of development sectors such as health and education, infrastructure, public administration, financial and private-sector development, agriculture, and environmental and natural resource management. The term Regional Development Bank usually refers to four institutions such as:

- African Development Bank (AfDB)
- Asian Development Bank (ADB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank (IDB)



Universal Banking

Universal Banking system is the conglomeration of banking and financial services under one institution.

They provide a wide range of financial services such as insurance and banking and investment activities.

Commonly, referred to as one stop shop that is involved in banking, stockbroking services. It is a combination of retail, wholesale and investment banking services under one roof.

Prior to the adoption of Universal Banking in Nigeria in 2001, commercial banks had been permitted to undertake some traditional merchant banking activities, such as leasing, investment advisory services, and some other fee-based services, while the merchant banks had been banned from offering retail banking services, including chequering account facilities. Merchant banks had not been admitted to the clearing house and had been subjected to restrictions on the minimum initial deposits they could collect from their customers. Those restrictions led to imbalances in opportunities, which reflected mostly in the diminishing profitability and viability of Nigerian merchant banks.



Universal Banking

Universal banking is a method of banking in which banks are permitted to offer a different kinds of banking and other financial services to their customers.

In this system of banking, there are no limitations as to the services being offered by banks.

The central bank of Nigeria in January 1, 2001 approved the introduction of universal banking.

This decision by CBN, consistent with the global trends towards liberalization and the need to provide a level playing field for banks, brought to the fore the need for consolidated and coordinated supervision of Nigerian banks across sectors. The need to provide a level playing field for banks, and the desire to strengthen their capacity to fund commercial and industrial activities, through the diversification of their services/products, the CBN removed the restrictions placed on the activities of banks and approved the introduction of Universal Banking, with effect from January 1, 2001. The application of monetary policy measures, such as the Cash Reserve Requirement (CRR), which had been limited to only commercial banks, was extended to all banks, thereby providing a level playing field for all Nigerian banks.

Universal Banking



ADVANTAGES AND OF UNIVERSAL BANKING

The universal banking system which offers varieties of banking services has its merits and usefulness to the society.

The usefulness of the universal banking is as follows;

Improved deviations and improved profitability (profitable diversification)

- Better Utilization of Resources.
- Leverage on Brand name
- Leverage on Existing clientele
- Value added services

A lot of transaction costs are saved on One-stop shopping'

DISADVANTAGES OF UNIVERSAL BANKING

The disadvantages of universal banking are as follows:

- Different rules and regulations
- There is event of failures on the banking system
- Monopoly
- Conflict of interest between banks and investors
- Poor risk management



Insurance Companies

An insurance company is a company that offers protection and bears the risk of its customer. These are institutions that provide safety in event of a probable adverse consequence. Insurance companies have been operating in Nigeria for a long time. Prior to the late 1950s, the insurers were only expatriates. And by the late 1950, indigenous companies started to emerge.

By 1961, the insurance company act was enacted to formalize, regularize and prescribe the modalities for the practice of insurance business.

The Nigerian insurance industry has shown modest growth since the 1960s when its regulatory framework was formalized by law.

Insurance business started in Nigeria in the colonial era and before 1950 was only conducted by foreigners. In 1961 the Insurance Company Act was ratified to formally regularize and adopt the modalities for the practice of insurance business with the Federal Ministry of Finance responsible for the licensing of new applicants/insurance company's into the business. The insurance sub-sector, which mobilizes long-term investible funds, is the second largest sub-sector in the Nigerian financial system, after the banking sub sector.

Health



Life



Travel



Insurance



Business



House



Car

More on Insurance Companies

An insurance company is an institution in the financial system that bears the risk of its customers.

It comprises multiple insurance agents that usually specialize on one type of insurance such as health insurance, life insurance, or multiple types of insurance.

It can also be seen as a company that provides coverage/help in the form of compensation as a result of damages/loss or injuries.

Insurance companies perform the following functions: mobilizing long term funds in the form of premium by providing life or non-life protection to customers; promoting economic growth by investing its premium and other income in the economy; and promoting the insurance business by contributing part of its income to a fund in the Nigerian Re-insurance Corporation. As a fallout of the bank consolidation exercise undertaken by the CBN, the insurance sub-sector companies were also required to recapitalize, raising the minimum capital requirement to N2.00 billion, N3.00 billion and N10.00 billion for life, non-life and reinsurance business, respectively, to enable the sub-sector meet the challenges of an increasingly global financial system. Furthermore, the insurance sub-sector has adopted the risk-based supervision approach to avert failure, in line with the developments in the banking sub-sector.



Operations and Regulations of Insurance Companies

Most insurance operations are regulated by the states, but there are some areas where the federal government exercises its regulatory authority. For example, federal law imposes penalties for fraud and false statements made in connection with insurance transactions. Anyone who is engaged in the insurance business and makes a false material statement for the purpose of influencing their actions can be subject to punishment. Also, Some federal regulations and actions affect insurance directly, such as the Fair Credit Reporting Act and a few programs that make coverage for terrible losses available, such as FEMA's (Federal Emergency Management Agency) National Flood Insurance Program, insurance is regulated primarily at the state level.

Operations:

The operations of an insurance company are as follows.

(a.) Ratemaking (b.) Underwriting (c.) Claim settlement (d.) Reinsurance etc.

It is the state that regulates insurance using some guidelines such as:

(a) Rates must be adequate (b.) Rates must not be excessive (c.) Rates must not be unfairly discriminatory



Common Characteristics of Risks Insured by Insurance Companies

A businessman who gets insurance against all possible risk of business, frees himself from the risk against which he has taken the insurance and thus makes himself available for more important and pressing work.

An insured businessman feels safe and free. Anyone who takes up life policy or general policy like fire, natural calamity, accident etc. makes himself free not only from family liabilities but with greater enthusiasm. Therefore, the characteristics of risks insured by insurance company are as follows;

- Large number of similar objects-A large similar risk pool is desired for insurance companies.
- Losses are accidental/unintentional-Needs to be unintentional in nature, avoid moral hazard/not gambling
- Losses can be determined/measured-If data is available, easier to make predictions
- Losses should not be disastrous-When one random event results in many losses, the insurance company has a big problem
- Large Loss Principle-Maximum possible loss needs to be sufficient (people do not buy insurance for inexpensive property/things).



**INSURANCE
PREMIUMS**



**INSURED
LOSSES**



Types of Insurance Products

Different types of insurance products exist and they differ across countries. Such as

- Home insurance and Car insurance
- Travel insurance
- Life insurance, critical illness,
- Income protection and Payment protection
- Private medical and dental Insurance
- Pet insurance
- Workers injury benefit insurance

Benefits of Insurance Policies

- Life insurance provides cash for dealing with the adverse financial consequences of the insured's death.
- The policy protects family and employees against the risk of premature death.
- Unlike any other financial instrument, Life insurance enjoys favorable tax treatment.
- Education policies make available cash on death or disablement of workers while the child is in college/university.

Type of insurance



Life Insurance



Home Insurance



Property Insurance



Auto Insurance



Health Insurance

Comparative Banking and the Financial System

Comparative Banking system is the study of, review and analysis of various Banking systems and the financial system in an economy.

The financial system encompasses all the institutions, markets and rules and regulation governing their operations. The banking sector is an important segment and sub-sector of the financial system. The Nigerian financial system comprise of two subsectors: (a) the informal and (b) the formal sectors. The informal sector is made up of the Local Money Lenders, the thrifts, savings associations, etc. on the other hand, the formal segment of the financial system can be sub-divided further into capital and money market institutions.

The banking sector is further classified but generally involved in the activities of intermediation, while the financial system include activities such as insurance, mortgage, stock dealing, mutual funds, etc.

Comparative Banking System offers one the ability to exchange banking ideas and also network in related fields of human endeavours especially in banking and finance. It also helps to identify the levels of development in the banking environment or banking industries of various nations



Nature of Islamic and Conventional Banking and Finance

The word Islamic banking is referred to as a banking activity or a system of banking that is likened to the rudimentary principles of Islamic Sharia (rules and values set by Islam). Islamic banking is also known as interest free banking system. This is because Sharia prohibits the acceptance of “Riba” or interest for lending of money.

Islamic banking has the same services as conventional banking system with the exception that it firmly follows the rules of Sharia or “Fiqh al-Muamlat”.

It is also called 'Non-Interest Banking'.

Peculiarities of Islamic Banking System

The peculiarity of Islamic Banking is built on the moralities of trade, sharing of gains, partnership, losses, and prohibition of reckless risk. It also prohibits:

- Interest - based banking
- Gharar–unclear contracts
- Maysir–speculation
- In Islamic banking, Profit sharing is fixed based on real profit.



ISLAMIC FINANCE

VS



CONVENTIONAL FINANCE

Comparative Banking and Financial System

The Islamic banking system adopts some of this ideologies as a primary mode or techniques of financing or funding. Such as:

MURABAHA

It is the sale on the profit which is mutually agreed by both parties.

IJARAH

This refers to the legal right against a certain return for the work or effort which is projected to be expended and for the rewards that are proposed to be taken.

MUSAWAMAH

It is the sales of goods in which the price of the goods or commodity is bargained between the buyer and the seller.

An alternative risk sharing technique offered by Islamic banks in stead of interest are characterized by flexibility. In conditions of free market, Banks can choose the most suitable formula or formulae, set the suitable profit margin or profit sharing percentages in accordance with their location of type of activity and disbursement or repayment conditions to go with the formula etc. Thus the actual socio-economic costs of providing goods/services to the community are better reflected in Islamic financing.



Differences between Islamic and Conventional Banks

The key difference between Islamic and Conventional banking is that Islamic Banking is grounded on Shariah foundation. Therefore, all trade, transaction, business approach, product feature, investment focus, and responsibilities are derived from the Shariah law, which lead to the major difference in many part of the operations of a conventional bank.

The formation of Islamic banking is based on the Islamic faith and must stay within the limits of Islamic Law or the Shariah in all of its actions and deeds.

The differences between Islamic and conventional banks are as follows: In conventional banking, interest is charged on its transactions while Islamic banking is based on interest free banking.

Conventional banks use money as a commodity which leads to inflation while Islamic banking inclines to create link with the real sectors of the economic system by using trade related activities.

In conventional banking, Time Value serves as the basis for charging interest on capital, while in Islamic banking, Profit on trade of goods or charging on providing service is the basis for earning profit.

Islamic Banking System



Conventional



Financial Inclusion

Financial inclusion is the deliberate policy of government to make available or create access of banking services or other financial products to the unbanked population of an economy.

It is the provision of financial services or banking services at affordable rate to the low-income parts of a society or to the unbanked section of an economy, mostly at the rural area.

It is taken by a nation's central bank to make available or accessible, banking services to its citizens. For instance, banks can employ agents that collect deposit from customers in the rural areas of an economy and help them to deposit the funds in the bank.

Financial inclusion has increasingly become widespread acknowledgment across the globe among researchers, policy makers and development oriented agencies. Its importance comes from the potential it holds as an instrument for economic development, particularly in the aspects of employment generation, poverty reduction, wealth creation and improving welfare and general standard of living. Mehrotra et'al (2009), emphasized that access to financial services allows the poor to save money outside the house, and helps in mitigating the risks that the poor face as a result of economic shocks.



Why Financial Inclusion?

Majority of the population mostly people living in the rural areas do not have access to financial services delivered by regulated financial institutions. As a result, being included in the financial system helps people to:

- a. Make day to day transaction such as; sending and receiving money
- b. Boost/safeguard saving
- c. Plan and pay for recurring expenses such as school fees and other bills
- d. Improve their overall welfare
- e. Handle uncertainties that require unexpected payment.

Targets of Financial Inclusion:

One of the targets of financial inclusion in Nigeria is to reduce financial exclusion to 20 per cent by 2020 from the 2012 level of 46.3 per cent. (i.e. to reduce the total number of people who are unbanked by 20 per cent.)

Also, financial inclusion aims at making banking services accessible by the unbanked and underprivileged population/ citizen of a country, through consumer protection and awareness.



The Concept of Interest Rate

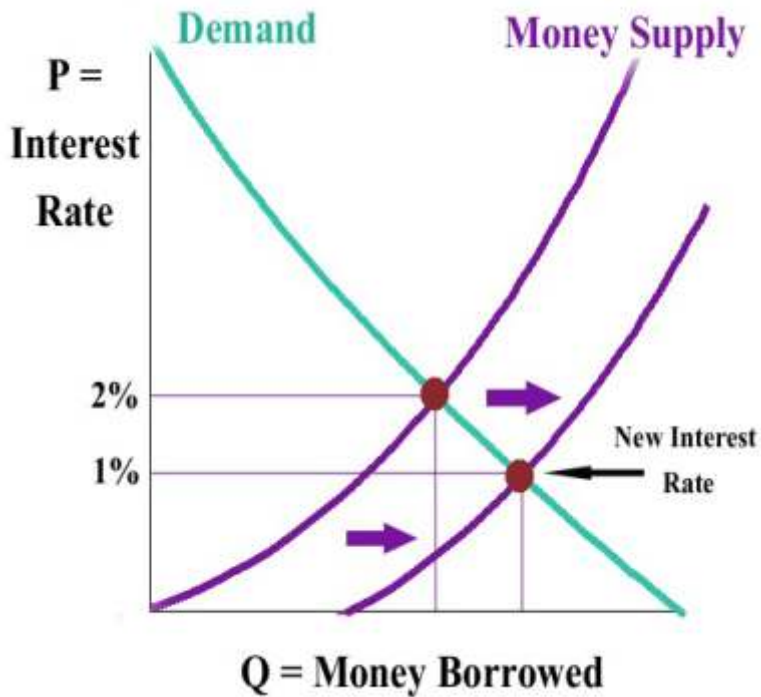
The Interest rate is money paid or charged per cent of the deposit or loan granted by bank or other financial institutions. It is a price for the use of an asset over a period of time, usually monthly, quarterly or annually depending on the period (tenor). It is guided by Monetary Policy Rate (MPR) which is under the control of Central Bank of Nigeria (CBN). When banks accept deposits they pay interest which is referred to as a deposit interest rate, when they grant a loan, they charge slightly higher interest rate to earn profit and recoup operational cost. Interest rates are usually taken on an annual basis, it is also known as an annual percentage rate (APR). The asset(s) loaned out might consists of consumer goods, cash, vehicles or buildings. Interests are principally a fee or lending charge to the borrower, for the use of the asset. Interest rate on larges assets are usually referred to as the "lease rate". A borrower is charged a low interest rate when he is considered a low risk party; and the borrower will be charged higher if he is considered a high risk party. Interest rates are one of the [economy's single strongest influences. The formula to find an interest rate of a loan is:](#)

$$\text{Interest Rate} = \frac{(\text{Total Repayment Amount} - \text{Amount Borrowed})}{(\text{Amount Borrowed})}$$



Structure of Interest Rates

Following the introduction of the Structural Adjustment Programme (SAP) in 1986, the CBN introduced a market-based or indirect interest rate system. The new system is a platform where the interest charged by the lender to the borrower is determined by the demand and supply of funds. The CBN also, influences the rate indirectly by reviewing MPR upward or downward depending on the overall economic objective of the country. Excess supply of money reduces market interest rates. While, low money supplies tend to increase market interest rates. The current level of liquid money (supply) synchronizes with the total demand for money (demand) to determine the interest rates. If you hold money, your opportunity cost is that income you get from bond or in other words, the interest rate. So, when interest rate increases, you want to hold more bonds and less money and vice versa. Thus, money demand and interest rate has an inverse relationship. The demand and supply curve for money shows the relationship between the quantity of money demanded, the quantity of money supplied and the interest rates. This is illustrated in the accompanying graph.



Deposit Rate

The interest rate a bank or financial institution pays on cash deposits is termed as a "Deposit Rate. Deposit rates are paid on savings and other investment accounts. It is the interest rate that banks pay to depositors for the use of their savings for the time period of the deposit. Deposit interest rates can either be fixed with a minimum amount for a certain period of time or it can be variable, this implies that it changes often and it is not often subjected to early withdrawal penalties. Cash paid into savings and investments accounts are compensated with a deposit rate. Savings accounts usually receive low interest rates, however, money deposited into other account types are also compensated with a deposit rate by banks and other financial institutions. In essence, the Deposit Rate is the interest rate that a bank pays the depositor for the use of their money for the time period that the money is on deposit. It usually differs from bank to bank, some pay higher than others. The longer the money stays with banks the higher the rate it attracts. The table below shows a list of some Nigerian banks with their various deposit rates.

S/N	NAME OF BANK	Demand Deposit %	Savings Deposit %	Time Deposit %
		Ave. Int Rate	Ave. Int Rate	Ave. Int Rate
1	Access Bank	0.06	3.6	6.56
4	Diamond Bank	0.46	3.6	6
5	Ecobank Nigeria	0.01	3.6	5.5
6	FCMB	0.61	3.3	8.5
7	Fidelity Bank	2	3.6	6.5
8	First Bank of Nigeria	-	3.6	6.65
11	Guaranty Trust Bank	0.7	3.6	6.28
13	Keystone Bank Ltd	0.6	3.6	11.39
15	Skye Bank	-	3.6	8.55
16	Stanbic IBTC Bank	0.01	3.53	5.63
17	Standard Chartered Bank	-	3.6	7.4
18	Sterling Bank	-	3.6	6.03
19	Union Bank	0.5	3.6	6.8
20	United Bank for Africa	0.05	3.6	6
21	Unity Bank	0.75	3.6	9
22	Wema Bank	0.67	3.6	6.5
23	Zenith Bank	0.5	3.6	5

Lending Rate

Lending rate refers to the interest rate at which banks lend to preferred customers with good credit. It is used in many countries by banks. A lending rate is referred to in some countries as a prime rate or a prime lending rate. There are two major types of lending rates in Nigeria; The prime lending rate and the maximum lending rate. Prime lending rate refers to the average prevalent lending rate charged by most deposit money banks in Nigeria to some of its more favored customers. Maximum lending rates refer to the average of the highest lending rates charged by deposit money banks in Nigeria.

The prime lending rate is also used in calculating rate changes often known as adjustable rate mortgages (ARM) as well as other variable short term loans. It is also used as a guide in calculating private student loans, credit cards, homes equity lines of credit, etc. Most of these loans have their variable interest rates that are specified as prime rates including a fixed value ordinarily known as a spread or margin.

The Figure is graph showing the trend of the Prime and Maximum lending rates in Nigeria from 2006 – 2016.

Lending Rates in Nigeria



Treasury Bill Rate

This is a rate earned from investing in Government short term debt obligation securities. The rate is usually higher when time to maturity for the bill is longer, which demonstrates the term structure of interest rate. It is also a yield on risk free instrument, because it is backed by the government with maturity of usually less than a year.

T-bills can be purchased at auctions held by the government, or from a third party individual or market which has been earlier issued. Treasury Bills bought at auctions are valued through an impartial bidding system at a discounted price from the par value. When the treasury bills are redeemed at maturity, they are compensated the par value amount. The difference between the buying price and the par value price is the interest. For example, if an investor purchases a T-Bill valued at N1,000,000 for N950,000. When this T-Bill matures, the investor is paid N1,000,000, thereby making N50,000 on the investment. T-bills usually mature between a few days to the maximum of 52 weeks, however, common maturities are 91-days, 182-days and 364-days. The longer the maturity date, the T-Bill will pay the investor a higher interest rate. An example of a 19th Century Nigeria Treasury Bill is depicted here.

FEDERAL GOVERNMENT OF NIGERIA

No.

Due

TREASURY BILL
(TREASURY BILL ORDINANCE, 1958.)

No.

£1000

LAGOS,

19 .

This Treasury Bill entitles
SPECIMEN or Order

to Payment of One Thousand Pounds at the
Central Bank of Nigeria, Lagos

on the day of 19 .

GENERAL MANAGER

SECRETARY

CENTRAL BANK OF NIGERIA

* IF THIS BLANK BE NOT FILLED IN, THE BILL WILL BE PAID TO BEARER.

Inter-Bank Rate

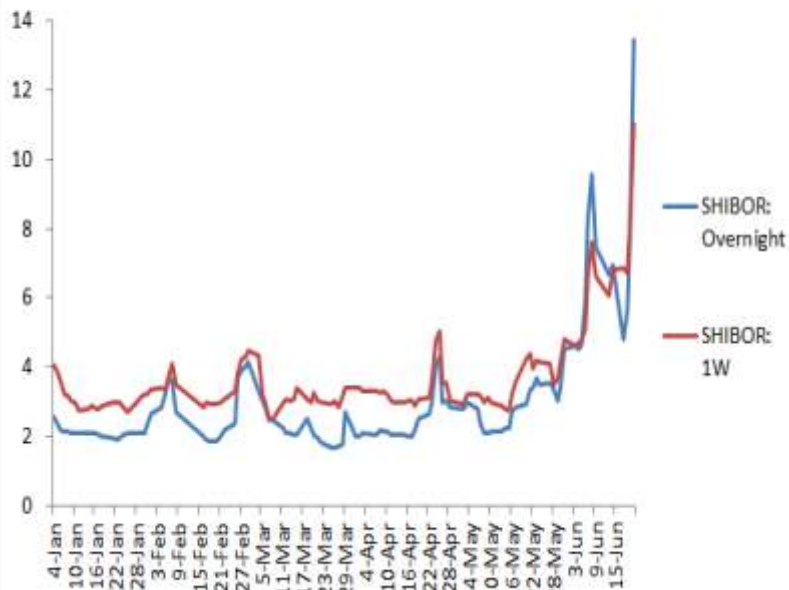
This can be described as an interest rate charged by the banks for short term loans extended to one another. The rate is determined by the availability of funds within the system.

Banks lend to and borrow money from each other in the interbank market, which enables them meet the reserve requirements placed by the monetary authority – i.e. Central Banks; as well as manage their various liquidities. The interbank rate can similarly be referred to as the price which banks use for wholesale FOREX transactions in both the spot and forward market; the margins are usually tighter for larger retail transactions than for small retail transactions.

It is mandatory for banks to hold sufficient amounts of liquid assets (cash) in order to accommodate withdrawal request from deposits of clients. Daily liquidity prerequisites are largely managed by borrowing to make up for shortages and also excess liquid assets are lent out. The availability of money in the market, the prevailing rates and the length of the contract is what determines the interest rate. There is a wide range of interbank rates which varies amongst countries, including the federal funds rate (USA), the LIBOR (UK) and the Euribor (Eurozone), SHIBOR (Shanghai), NIBOR (Nigeria), etc.

Interbank Rates

Percent



Monetary Policy Rate

Monetary Policy is a deliberate effort by the central authority of a country e.g. Central Bank to control the supply of money often targeting interest rates and inflation rates to certify price stability and also to improve the currency. The Monetary Policy Rate (MPR) is a short term anchor rate designed to influence other money market rates. It is usually fixed to promote policy efficiency. The MPR is set by the Monetary Policy Committee (MPC) to guide the short term rates and correct any imbalances that arise from monetary under or over supply to the overall economy. The rate of interest at which the Central Bank of Nigeria lends money to commercial banks is called an MPR. At present, the MPR is at 14 per cent. A decrease in the MPR implies that banks can borrow more at a lower cost this releasing more money into the economy. If the central bank raises the MPR, the cost of funds for banks goes up. This reduces the level of liquidity in the system.

The transmission mechanism of the monetary policy rate is depicted in the accompanying diagram here.

Transmission Mechanism of Monetary Policy

1 / Change in market interest rates

Normally a change in policy interest rates feeds through to borrowing/saving rates

2/ Impact on demand

Effect on spending, saving, investment and exports

Is there an expansion of production and employment?

3/ Effect on output, jobs & investment

Rate changes then affect two of the key macro objectives

4/ Real GDP and Price Inflation

It can take between 12-24 months for the **full effects** on real GDP and the inflation rate after a change in policy interest rates

Components of Interest Rates

Real Risk-Free Rate

The real risk-free rate is the lowest return an investor would expect from an investment over a period of time. It does not take into account expected inflation and the capital market environment.

Expected Inflation

This can be described as economic agent forecast on the likely outcome of general prices. The sentiment often influences the market towards its direction.

Default Risk Premium

This is a payment indirectly made by borrowers through the rate at which they pay their obligation.

Liquidity Premium

This is a payment demanded by an investor for securities that has a longer term before liquidated in to cash.

Maturity Premium

This applies to a long term security that pays a fixed interest rate. It is paid to compensate change in the rate for those investments that are locked up in long term investments.



Nominal and Real Interest Rates

A real interest rate is an interest rate adjusted for inflation. It measures the increase in the purchasing power (wealth) and not just financial terms. Whereas a nominal interest rate is the real interest rate inclusive of the inflation rate and they are not determined by nominal variables like inflation and money supply rather by the demand and supply of loanable funds. Therefore, if there is inflation, the real interest rate does not change but the nominal interest rate changes to ensure the increase in purchasing power remains constant despite the high inflation. E.g. if you borrow N100 at a 7% interest rate per annum, the nominal interest rate is N7. Note that N7 included the rate of inflation for that year.

A real interest rate is the interest rate after deducting inflation from the nominal rate. In contrast, with the nominal interest rate, the real interest rate does not include inflation and represents the real rate of a bond or a loan. For example, when you loaned a person N100,000 to purchase a car at a 4% rate. The 4% rate is the nominal interest rate, because it includes inflation.

Comparing Real and Nominal Interest Rates

**Nominal
Interest
Rate =
8%**

Inflation Premium = 5%

Real Interest Rate = 3%

Short Versus Long-term Interest Rate

Interest rate refers to money charged to the borrower by the lender. The money lent could be a short or long term loan, and it depends on the agreement between the lender and borrower. Short term interest is usually charged on loans that have tenor of less than a year. The interest charged is not very high when compared to long term loans, because it's less risky. While a long term interest rate is usually paid on deposit and investments that have tenor of long periods mostly over a year. The interest charged on this type of loan is usually higher due to its long term nature which makes it risky. Inflation and expected inflation are key variables between short and long term interest rates. Long term interest rates are determined by market forces – i.e Demand and Supply; which determine equilibrium price for long term bonds and also fix long term interest rates. When the market believes the Federal Reserve Board's Open Market Committee (FOMC) has set the fed funds rate too low, the expected inflation rate also increases, which is in relation to short term interest rates, and vice-versa.

Short Term vs. Long Term Loans

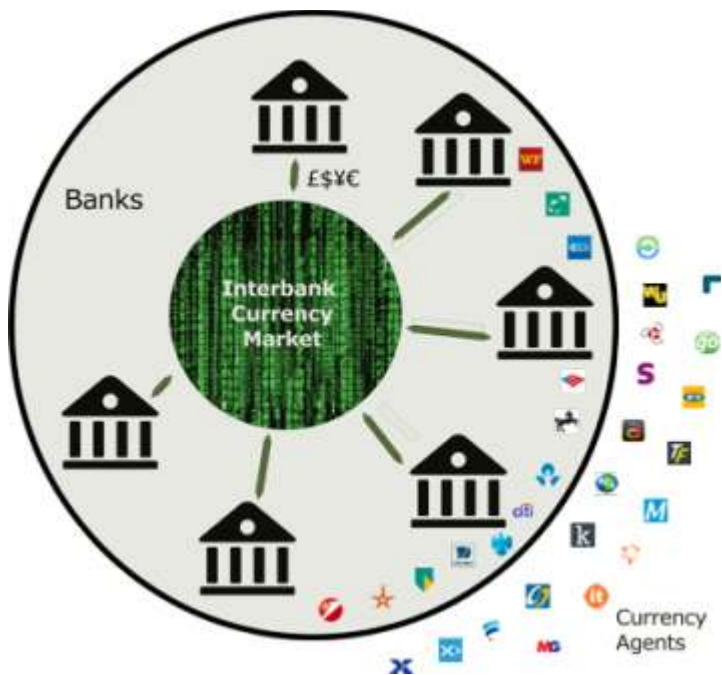


SWIFT CAPITAL

Transactions in the Inter-bank Market

The transaction at the Interbank Market is short term, usually overnight and short tenured loans that banks grant to themselves for statutory reserve replenishments. Commercial banks are by law required to keep certain percentage of their customers' deposits for monetary policy and some other regulatory purposes. Those banks that are less liquid borrow from others that have a surplus at an agreed rate called the interbank rate which is determined by the availability or otherwise of the funds.

The loans are in two (2) categories; Interbank (uncollateralized); this does not require any asset or security as pledge for the loan. While, Open Buy Back (collateralized) requires the borrower to surrender some assets or securities to the lender before the loan is granted. Banks use the interbank market for liquidity co-insurance as traditionally assumed. However, the importance of the liquidity management function is higher for regionally-focused credit cooperatives and savings banks than for private commercial banks.



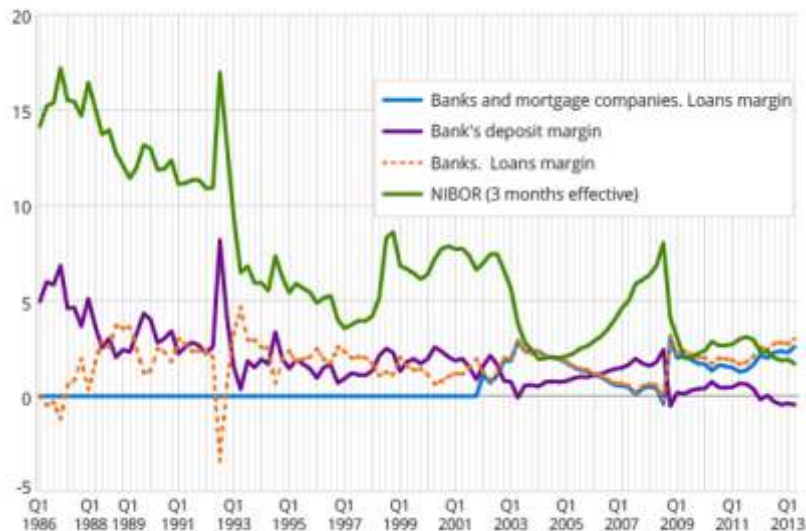
Types of Inter-bank Rates

Nigeria Inter-Bank Offered Rate (NIBOR)

The Nigerian Interbank Offered Rate (NIBOR) represents the short term lending rates of selected banks in the interbank market often cited as annualized rates. NIBOR is a “polled rate”, which implies that quotes are submitted by some selected Nigerian banks known as “Reference Banks” which are processed to give NIBOR. It is a vital element of the Nigerian financial system. It is used as a floating rate index for financial contracts i.e. retails loans, money market instruments, bonds and interest rate derivatives and long dated mortgages.

Figure 2. Interest rate margin on loans from banks and mortgage companies, deposit margin and NIBOR at-end quarter. Q1 1986-Q2 2013. Per cent

Per cent



Source: Statistics Norway.

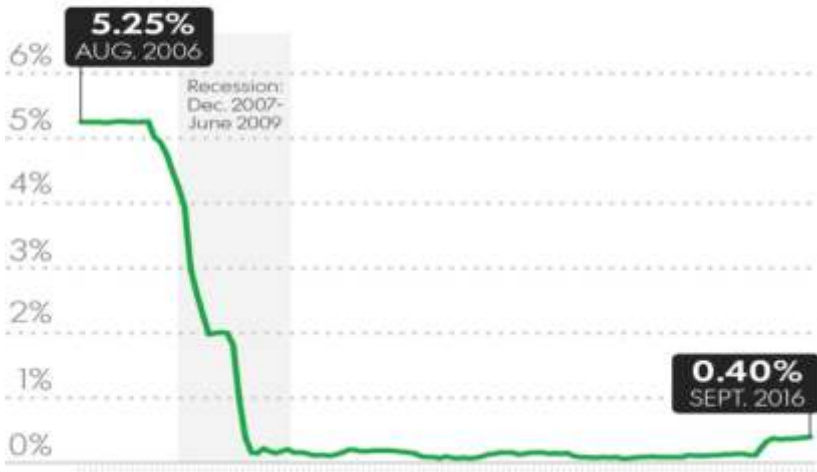
U.S.A Federal Fund Rates

The US Federal Fund Rate is a rate which depository institutions charge themselves on overnight loans. It is the interest rate banks and other depository institutions lend and borrow amongst themselves on an uncollateralized basis to meet daily reserve balances requirement on overnight basis to meet up required reserve short falls. Depository institutions keep their reserve requirements with the Federal Reserve. This is known as reserve balances. Depository Institutions with excess balances in their accounts lend the excess to other institutions that need to meet up with the requirements. It is also known as a base rate that guides the general interest rate and monetary conditions in the economy. The upper and lower bench mark of the rate is set by Federal Open Market Committee (FOMC), which is vested with powers for decisions on monetary policies and operations guidelines.

The rate at which the loan is lent is negotiated between both institutions; the weighted average of this rate is the federal funds effective rate. The rate is determined by committee members of the FOMC. The Meetings hold eight times a year.

FED FUNDS RATE UNCHANGED

The Federal Reserve said Wednesday it would keep the Federal Funds Rate — the interest rate at which banks trade federal funds — unchanged at 0.40%.



SOURCE Federal Reserve of St. Louis
George Petras, USA TODAY

 **USA TODAY**

UK Libor

London Interbank Offered Rate (LIBOR) is the average interbank interest rate which banks in the London money market lend uncollateralized British pounds sterling denominated loan to members. The British pound sterling (GBP) LIBOR interest rate is available in 7 maturities; overnight, one week, and 1, 2, 3, 6 and 12 months. Libor is widely used as a reference rate for various financial instruments in both financial markets and commercial fields. The UK LIBOR rate is used to calculate various interest rates on different loans throughout the world. It is based on five currencies – i.e the pound sterling (GBP), Euro (EUR), U.S. dollar (USD), Swiss franc (CHF) and Japanese yen (JPY). It is also managed by the ICE Benchmark Administration (IBA). A total of 35 different LIBOR rates are used each business day. With the most common being the U.S dollar rate. The LIBOR curve is the graphical representation of various maturities of the London Interbank Offered Rate (LIBOR), which is the short-term floating rate at which large banks with high credit ratings lend to each other.

**LONDON OFFERED
INTERBANK RATE**



Eurozone EURIBOR

The Euro Interbank Offered Rate (EURIBOR) is the average interbank interest rate for Euro denominated loans extended to members. The Euro Interbank Offered Rate (EURIBOR) is a daily reference rate, given by the European Money Markets Institute. It is often based on the averaged interest rates at which Eurozone banks offer to lend unsecured funds to other banks in the interbank market. The most important reference rates in the European money market are the EURIBOR rate. The origin for the rates and price of the different types of monetary products such as savings accounts, interest rate futures, mortgages and interest rate swaps is provided by the EURIBOR rate. Due to this fact, many institutions and experts observe the change in the EURIBOR rates diligently. Up until November 1st 2013, there were 15 EURIBOR rates. Currently EURIBOR rates are available in only 8 maturities; 1 and 2 weeks, 1,2,3,6,9 and 12 months.

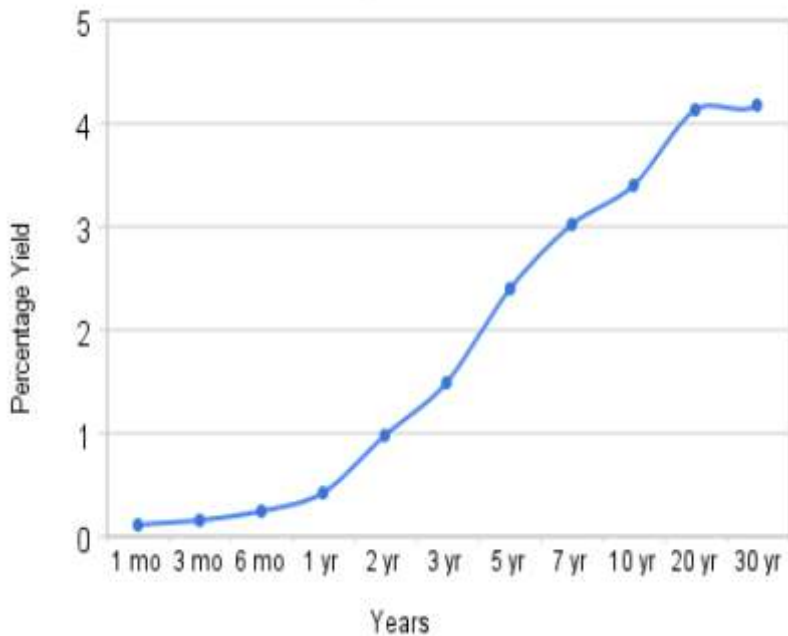
Many European banks come to an agreement in deciding the EURIBOR rates therefore the rates are determined by the demand and supply in the money market. Nonetheless, other external factors, such as inflation and economic growth also affect the EURIBOR rates.



What is a Yield Curve?

The yield curve is a curve that plots several yields or interest rates having similar credit quality but different maturity dates. The curve illustrates the relationship between the level of interest rate and maturity date, known as the "term", of the credit in a particular currency for a particular borrower. It signifies the correlation between short and long term interest rates, mainly in government securities. Market analysts examine the yield curve for a number of purposes, however, its main purpose is to serve as a forecast for inflation and recession. Therefore, the yield curve is examined by economists and investors in order to predict the future course of the economy. Monitoring the yield curve closely is of great importance so as to note significant interest rate changes that affect finance costs therefore affecting expenditure decisions of various businesses across all market sectors in the economy.

Treasury Yield Curve



Forecasting tool for Business Cycles

Business cycle forecasting is the creation of assumptions about how the business cycle will unfold in the future. It is a planning tool that aids management to predict the future and its uncertainties, using past and present data as well as analyzing trends. Forecasting primarily begins with assumptions that are founded on the experience, judgment and knowledge of the management. These assumptions are forecasted into the future months or years using models such as the Delphi method, Box Jenkins autoregressive (AR) models, and regression analysis, moving averages, exponential smoothing and trend projections. Errors in the assumptions often result to errors in the forecasting, thus, the technique of sensitivity analysis is used to assign a range of values to the uncertain variables. There are a number of forecasting tools that can be used for business cycles, however they all fall into one of two overarching categories; Qualitative and Quantitative models.



Qualitative Models

Qualitative analysis is a business model form of analysis that uses personal assumptions founded on incalculable data, like industry cycles, management expertise, strength of research and development, and labor relations. The difference between qualitative and quantitative analysis is that quantitative analysis focuses on numbers that is gotten from reports like balance sheets. Both are however used together in the evaluation of a potential investment opportunity and a company's operations. This model is also used in forecasting a company's success in the short term. Due to its dependence on individual opinions and , it has some limitations.

Market Research relying on qualitative models is a method of sampling a large number of people on a particular product or service to forecast the number of people that will buy or use it after it is produced. The Delphi Method is done by asking field specialists for their general opinions and then compiling them into a forecast.

Qualitative



Quantitative models

These methods are completely concerned with data and relying mainly on empirical analysis of the data. Quantitative models include:

- The Indicator Approach:** it depends on the correlation between assigned indicators like unemployment rates and GDP remaining fairly unaffected over time. By observing the correlation and observing the indicators, one is able to estimate the performance of the lagging indicators by use of the major indicators data.
- Econometric Modeling:** This method is more mathematical than the indicator approach. Econometric modeling examines the principal stability of data sets over time and the importance or strength of the correlation between data sets. It can also be used to create custom indicators that can be used more accurately.
- Time Series Methods:** This method uses various methodologies to predict future events with past data. In following past trends, the forecast is able to give an above average prediction about the future.

Quantitative

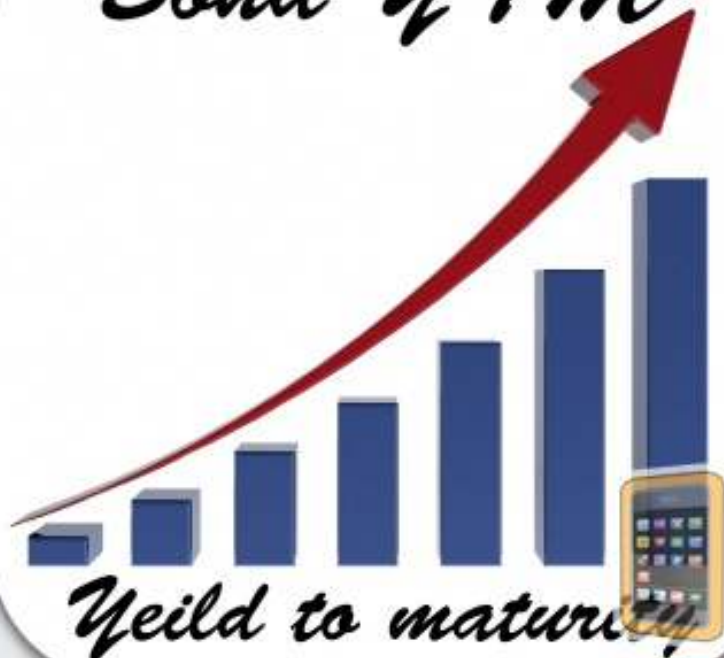


Yield to Maturity

Yield to maturity (YTM) is the total profit expected from a bond if the bond is held until maturity. It is thought to be a long term yield, thus it is expressed as an Annual Percentage Rate (APR). More so, it is also regarded as the Internal Rate of Return (IRR) on an investment assuming the bond is held until maturity and all payments are made on schedule. Yield to maturity is the discount rate at which the sum of all future cash flows from the bond is equal to the price of the bond.

While calculating a yield to maturity, all reinvestments are meant to be at the same rate as the current yield which also considers the bond's current market price, coupon interest rate, par value, and term to maturity. Its significance is paramount when estimating the potentials of a bond and if it is a good investment. If the YTM of a bond is determined by an investor, it can therefore be compared with the required yield to determine if it is good or not. The formula for calculating the yield to maturity is; $YTM = [(Face\ value / Bond\ price)^{1/Time\ period}] - 1$

Bond YTM



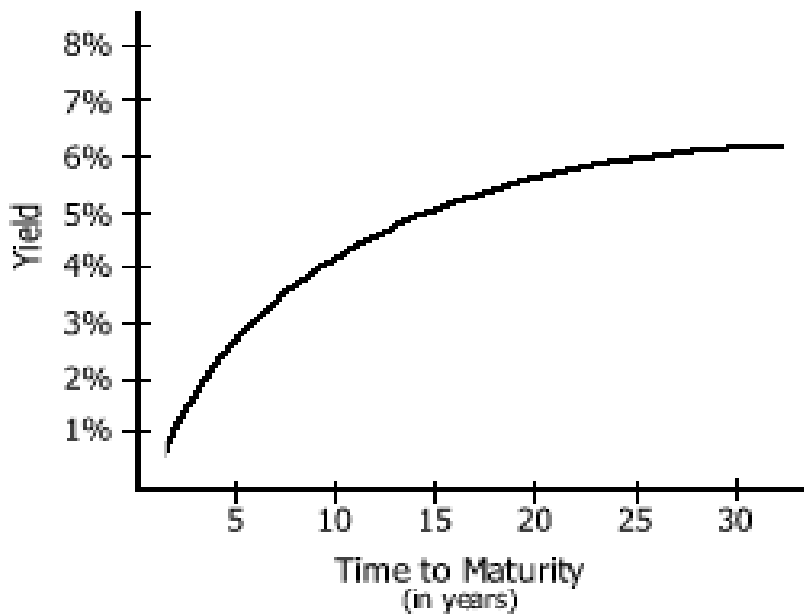
Yeild to maturity

Types of Yield Curves

Normal Yield Curve (Upward sloping or positive)

This type of yield curve is ordinarily/normal, meaning that as the yield rises, maturity lengthens i.e. the slope of the yield curve is positive. This positive slope depicts that investors expect the economy to grow in the future. It shows growth to be associated with a greater expectation to an increase in inflation rather than a decrease. This yield curve is termed "normal" because the market expects a higher compensation for a higher risk. Long term bonds are vulnerable to more risk such as an increased exposure to defaults and changes in interest rates. When an investor purchases a bond, it means he is unable to use the money for other expenditures, so he therefore compensated for it through the concept of time value of money. A normal yield curve slopes upward to signify the association of higher yields and longer term investments. The investors are therefore rewarded for the increased risk involved in long term investments, and low risks for short term investments. It is most commonly associated with positive economic growth.

"Normal" Yield Curve

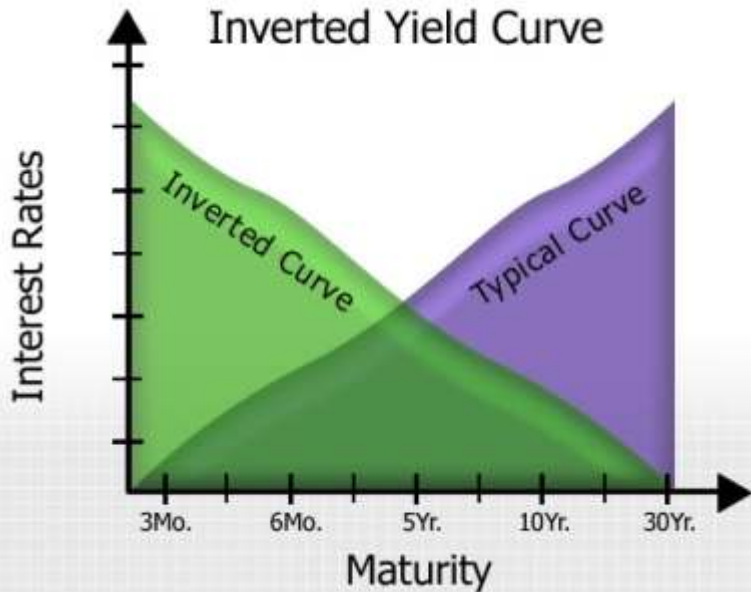


Inverted Yield Curves (Downward Sloping /Inverse)

An inverted or downward-sloping yield curve occurs when long-term yields fall below short-term yields. An inverted yield curve illustrates long term bonds that have lower yield and short term bonds of the same credit quality. This type of yield curve is extremely rare and indicates that yields on longer-term bonds may continue to decline, parallel to periods of economic recession.

The Federal Reserve sees this as a significant forecasting tool that can predict two to six quarters into the future. The inverted yield curve implies that the market believes inflation will remain low while signaling an economic decline. This is as a result of the fact that a low bond yield will still be offset by low inflation even in times of a recession. However, practical factors, such as global economic stability or currency situations, may cause long term rates to fall due to an increase in demand for bonds on the long end of the yield curve.

Inverted Yield Curve



Flat Yield Curves

A flat yield curve is observed when all maturities have similar yields. It indicates signals of uncertainty in the economy. This can mean that bond investors expect the economy to either stagnate or slip into a recession. The yield curve flattens when the difference between yields on long term bonds and yields on short term bonds decreases, therefore, it seems less steep.

The flat yield curve depicts little variance between long term rates and short term rates for bonds of the same credit quality. This type of yield curve is often seen when transitioning between a normal and an inverted curve. A normal yield curve slopes upward while a flat yield remains flat as the name implies.

A yield curve flattens when the returns from long term interest rates fall more than short term interest rates. Or when short term interest rates increase more than long term interest rates. A flat yield curve is normally a sign that investors are bothered about the macroeconomic outlook. Another reason the yield curve may flatten could be relative to inflation expectations from market participants to decrease or for the Federal Reserve to raise the funds rates in the near future.

Flat Yield Curve

Y
i
e
l
d

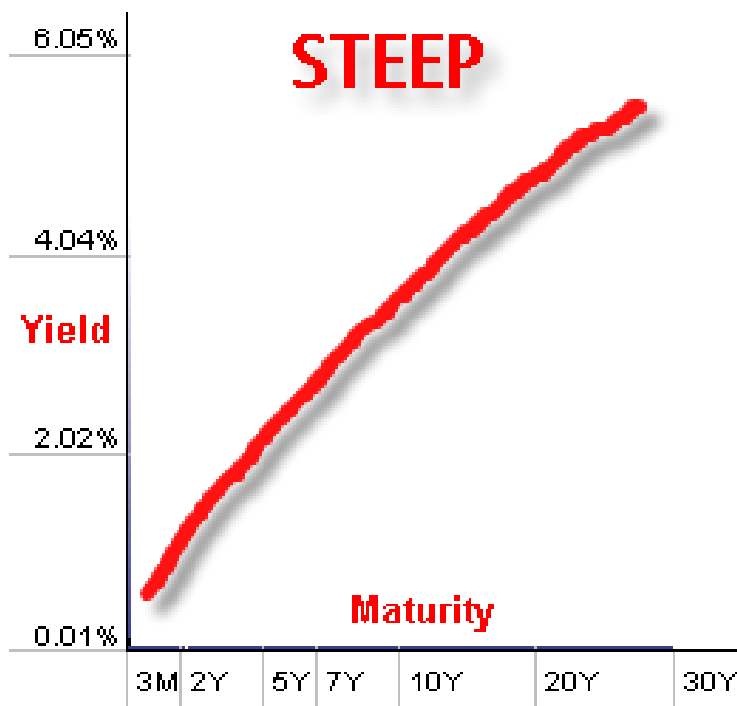
Maturity



Steep Yield Curve

A steep yield curve refers to a rapidly upward sloping line plot used to illustrate the difference between short and long-term investments at various dates of maturities. It is a variation of the normal yield curve, possessing the same basic properties; whereby the interest rates paid on securities with shorter maturities is lower than rates paid on debt with longer maturities.

This yield curve depicts expected rapid improvement in the future of the economy. Generally, the average of the 20-year Treasury bond yield is approximately 2% higher than that of the three month Treasury bills. In events like this, the economy is likely to progress rapidly in the future. This type of curve is usually seen at the start of an economic expansion or nearly after a recession. In this case, economic stagnation will have low short-term interest rates which will start to incline when the demand for capital is re-established by an increase in economic activity.

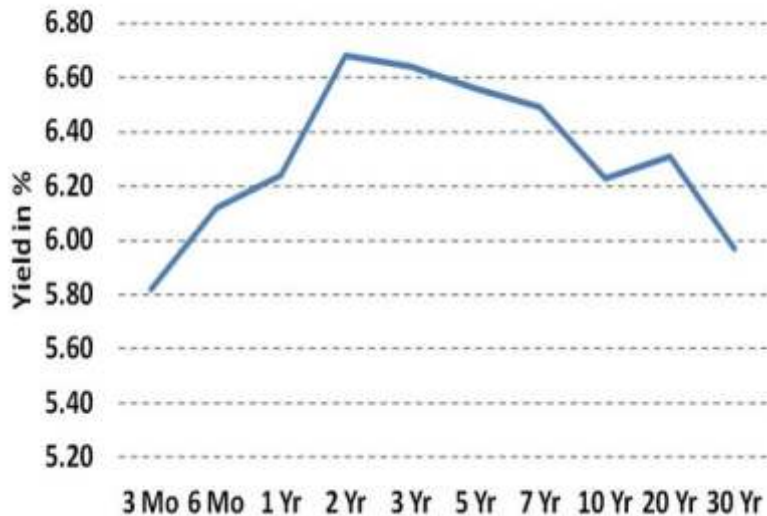


Humped Yield Curve

A humped curve occurs once a short term yield and long term yield are identical, and also when a medium term yield pushes higher than a short and long term yield. The term humped yield curve refers to a bell-shaped curve, indicating mid-term rates that exceed both long and short term rates. When investments of related credit quality, lead to a humped yield curve, it is usually understood that the economy is moving at a slow pace.

For instance, if the return on a 5 year investment is higher than a 2 and a 10 year investment, individuals will choose to invest in the shorter term security. This is because they would not be compensated for the additional risk they are incurring. This would eventually push the returns on investment higher and investors would move to the midterm investments, eventually bring down the rates.

Humped yield curve on April 28, 2000



Concept of Present Value

Present value (PV) is the current worth of a future sum of money or stream of cash flows given a specified rate of return. The present value is always less than or equal to a future value because money is always worth more now than later. PV is also referred to as the "discounted value". Because money has interest earning abilities, the present value is always less than the future value of money, a phenomenon known as the "time value of money", excluding when we have negative interest rates, the present value will be more than the future value. A lender may give you 900 naira for the promise of receiving N1000.00 a month from now, however, the promise to receive that same N100.00 naira 20 years into the future would be worth much less today to that same person (lender), even if the payback was similarly definite. Present and future value calculations are used to assess the value of loans, sinking funds, annuities, perpetuities, bonds, mortgages, etc.

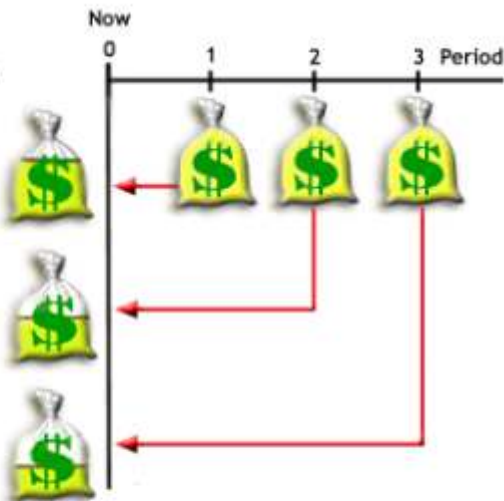
Since time dates must be steady in order to make comparisons between values, these calculations are used to compare various cash flows that do not occur in real time. The choice between investing in two projects can be made by calculating their individual present values by discounting and comparing them. The investment with the highest present value should be chosen.

Present Value of an Ordinary Annuity

$$= \frac{\text{Coupon}(\$)}{(1 + \text{interest rate})}$$

$$= \frac{\text{Coupon}(\$)}{(1 + \text{interest rate})^2}$$

$$= \frac{\text{Coupon}(\$)}{(1 + \text{interest rate})^3}$$



Sum of the above equals the present value of an annuity formula:

$$PV = PMT \times \left[\frac{1 - (1 + i)^{-n}}{i} \right]$$

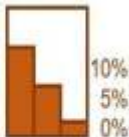
Where: PV = Present Value
PMT = Coupon Payment
i = Interest rate
n = Number of periods

Interest Rate Management in Nigeria

Interest rates in Nigeria are managed by The Central Bank of Nigeria through adjustments of the MPR. This affects all other interest rates at which banks are able to lend out funds. Interest rates have a direct impact on the amount of money in circulation. In Nigeria, the Central Bank raises or lowers the Monetary Policy Rate - i.e. is the interest rate that it charges banks for borrowing money - to either constrict or expand money supply. When the Central Bank lowers the MPR, banks in turn lower their lending interest rates, thus increasing borrowing, which increases the amount of money in circulation in the economy. When the Central Bank wants to reduce the amount of money in circulation, it raises the Monetary Policy Rate, which results in higher interest rates and fewer loans, thus reducing the money in circulation in the economy.

Interest rate risk exists in interest earning investments, such as loans or bonds, due to variability in the interest rates which could change the investment value.

Low Interest Rates



More Borrowing

Overdraft

LOAN

Mortgage

More Spending

More Demand

Orders

Sales



Control Regime

This refers to a tightly controlled system where the Central Bank sets monetary policy and other interest rates based on quantitative targets, such as loan quotas. One of the instruments used by central banks to control interest rates is by Open Market Operations (OMO). A central bank may indirectly interfere in the economy of its country by buying government securities. This event causes the Bank to be forced to raise the price of the securities in the open market thereby leading to the reduction in interest rates and other general interest rates. Interest rates are tools of monetary policy and therefore are useful in regulating variables like inflation rates and investments. In history, interest rates have been administered by national governments or the monetary authorities. The MPR in Nigeria increased from 6.00% to 14% from 2010 to 2017. Differences in the base rate of the Bank of England from 1989 to 2009 measured from lowest 0.5% to a high of 15%. But it is not ideal to control the interest rate as an annualized rate offered by a central bank on overnight deposits. An Example of a controlled interest rate economy is Nigeria.



Liberalized Regime

This a market system where policies and interest rates are based on market forces setting the rates and, hence, allocating capital. It is a relative term. It doesn't just mean suddenly letting go of all control (by say a central banker) rather it is a process of easing off or releasing control to market forces. Implicit in that, though, is the idea that less control is better.

For various historical and sometimes very practical reasons interest rates have at times (in many, if not most places) been set by a central authority. It may be to help smooth the effects of a major economic or political transition, or to control temporarily unbalanced forces or whatever, but it has been done to gain an advantage of some sort. But as an economy matures or recovers and strengthens the argument for control lessens. An example of a liberalized interest rate regime is the Peoples Republic of China.



What is Exchange Rate?

The exchange Rate is the worth or value of a currency being bought or sold to facilitate trade, either now or in future. It is the worth of a country's currency in relation to other currencies. An exchange rate hence has (2) two constituents: the local and external components, and could be cited indirectly or directly. Quoting directly, the worth of an amount of foreign currency is stated in relation to the local currency. In an indirect quote, the worth of a unit of local currency is expressed in terms of the overseas currency. A rate which does not have the home currency as one(1) of the two (2) currency elements is described as a cross currency, or cross rate.

A currency price includes a base currency and a counter currency. For a direct quote, the overseas currency is the base currency and the home currency is the counter currency. For an indirect quote, the home currency is the base currency and the foreign currency is the counter currency. Usually an exchange rate uses the US (\$) dollar as the base currency while other currencies are used as the counter currency for rate quotation.

CURRENCY			BELI BUYING	JUAL SELLING
 UNITED STATES BESAR	USDB		96 15	96 45
 UNITED STATES KECIL	USDK		95 65	96 20
 UNITED STATES \$1	USD\$1		90 15	95 15
 USD TRAVEL CHECK	USDTC		94 00	
 EURO	EUR		130 35	130 55
 AUSTRALIAN DOLLAR	AUD		6 65	7 00
 SINGAPORE DOLLAR	SGD		6 50	6 58
 JAPANESE YEN	JPY		93 50	94 50
 HONGKONG DOLLAR	HKD		12 35	12 45

Types of Exchange Rate

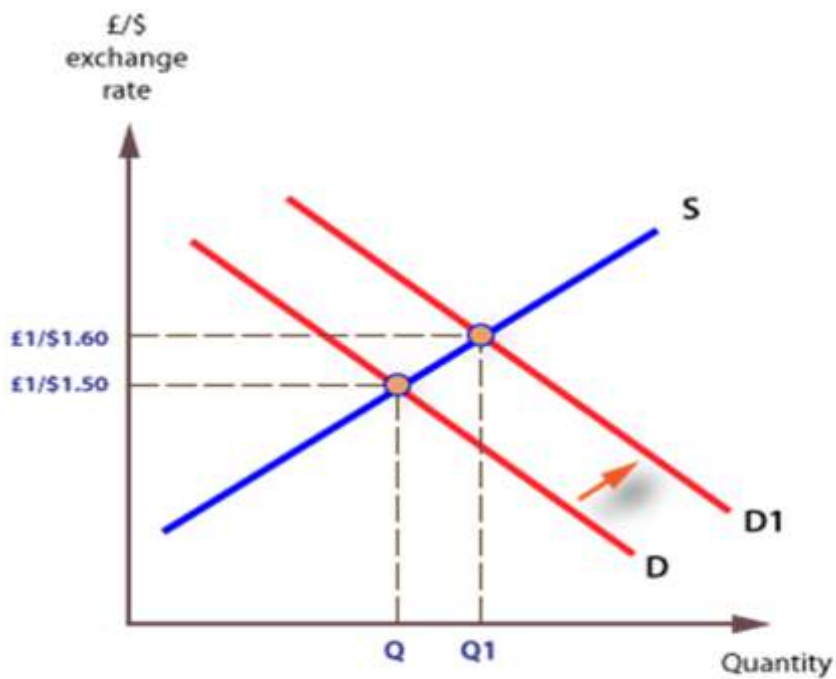
Currency prices can be fluctuating or static. Floating exchange rates describe currency rates that are arrived at through market forces: These remain the standards for majority of countries. Some countries choose to peg or fix their local currencies to a generally accepted currency like the US (\$) dollar. This defines the fixed exchange Rate. Exchange rates can be a mixture of both floating and fixed. This is an arrangement in which the foreign exchange rate is arrived at by price mechanism and the central bank stimulates the exchange rate through its influences in the foreign exchange market. It is a combination of a fixed exchange rate and a flexible exchange rate structure. In this system, the central bank mediates in the foreign exchange market to control the fluctuations in the exchange rate within certain limits. The purpose is to keep exchange rate close to desired target values. To achieve this, the central bank keeps reserves of foreign exchange to ensure that the exchange rate stays within the desired value. This is also labelled as 'Dirty Floating'. Exchange rates are also branded as the spot rate. This is the forward rate – or a current rate, which is the spot rate attuned for interest rate variations.

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Foreign Exchange Rates

Importance of Exchange Rate

Exchange rate is very important because it determines the confidence of the rest of the world in the economy of the nation. For example, if an exchange rate is unstable, foreign investors will be impaired from precisely predicting their investment returns. Even when they invest in holdings that give consistent and secured returns in a foreign currency, if that foreign currency is disposed to radically change its value, then the investment is equally unpredictable. Also, a currency with high value inspires importation while depressing export markets. This is as a result of foreign financiers being able to increase their return on investment through making money in a currency that goes far in their nation. On the other hand, exports are wounded, because they do not worth as much abroad as they are locally. However, a currency that has a low value inspires exports and depresses imports. This result from the fact that goods sold abroad for higher value currencies are worth even more than to bring goods into a country, and if they do, importers must mark these goods up to recover their losses due to the low currency rate face value just because of the currency value. On the other hand, there is little incentive for importers.



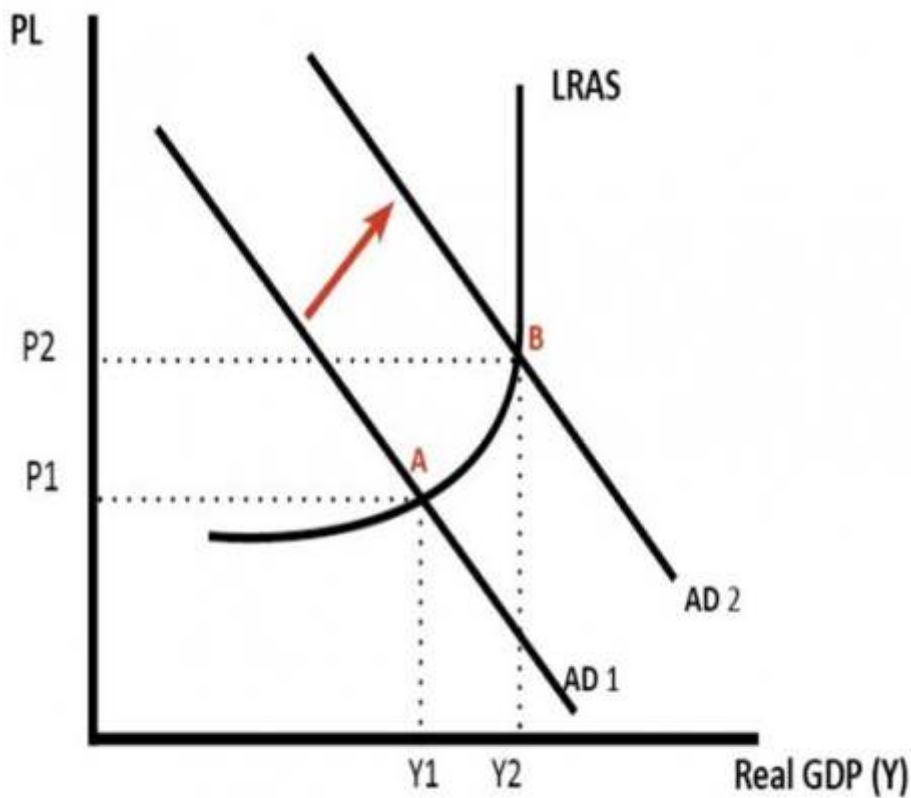
Exchange Rate Movements

The Exchange Rate can go up or down at a particular point in time. Exchange Rate Movements represent official fluctuations in the worth of a country's currency relative to other currencies. An exchange rate is determined by the supply and demand for the currency in a Floating Exchange Rate System. If there is greater demand for Naira, it would cause the value to increase and vice versa. In a Fixed Exchange Rate System, the movement is carried out by Monetary Authority and to a great extent motivated by market pressures.

The effective exchange rate measures the worth of a currency alongside a basket of other currencies. This exchange rate index is generally trade-weighted to take into consideration the comparative position of other currencies.

When considering the effective Naira exchange rate, we will relate the value of Naira against the currencies of our main trading partners – The Dollar, the Pounds, the Yen etc. and give a weighting subject to how much we trade with that currency, e.g. US Dollar 75%. A weight will be assigned to different trading countries based on their level of significance.

An appreciation in the Naira effective exchange rate means that on average the Nigerian currency is growing in value relative to that of our main trading partners



What is Foreign Exchange Market?

Foreign Exchange Market is market for buying and selling foreign currencies. The market provides avenue for buyers and sellers to interact and negotiate a mutually acceptable price for settling transactions. Currencies dominate the major means of exchange for international transactions. It is a market in which members can sell, buy, speculate and exchange on currencies. Foreign exchange markets consist of commercial companies, investment management firms, banks, central banks, hedge funds and retail forex brokers and investors. It is also known as Forex Market. The forex market is seen as the largest financial market in the world. Aside from providing facility for exchanging, buying, selling and speculation of currencies, the forex market as well allows currency translation for transnational investments and trade. The market has distinctive features and assets that make it an effective market for stakeholders that work towards improving their returns. The market has attracted diverse currency traders from all over the globe because of its rewards. In the foreign exchange market, as a major market closes, another in other parts of the globe opens. The opportunity provided in the forex market is one of the main forms of leverage that dealers and stakeholders can make use of.



Determinants of Foreign Exchange Market Rates

A number of factors contribute to the determination of Exchange Rates. The factors are associated with trading relationship existing between two countries. Note that Exchange Rates are relative and are stated as comparison of currencies of two countries. The following main determining factors of Foreign Exchange Rates between two countries are highlighted below:

Gross Domestic Product (GDP) which is the monetary worth of goods and services produced in a nation within a particular period (usually a year); Inflation (A country with a persistently lower inflation rate will experience appreciation in the value of its currency; Productivity (An increase in the productivity of factors of production within an economy (all other things being equal) will lead to reduction in cost of production in the system); Interest Rates (Higher interest rates offer investors in an economy a higher return relative to other countries); Balance of Payment (accounts of all economic dealings between the residents of a country and the rest of the world for a specific period). If the price of a country's exports increases by a higher rate than that of its imports, its terms of trade have favorably improved; Current Account Balance; Demand and supply of foreign currencies; Government policies; Perception of political stability and Speculative positions.



Types of Foreign Exchange Market Transactions

Transactions in the Foreign Exchange Market are categorized based on nature and effective time of the transactions. The following are the various types of transactions in the market:

Spot: FX spot is an arrangement between two entities to buy one currency against selling another currency at a settled price for clearance on the spot date. **Derivatives:** A derivative is a financial instrument whose performance is derived from, or depends on, another item or asset. The asset is called the underlying asset, which in this case, is currency. The derivatives can be used for hedging risk and for speculation, thus, increasing risk exposure.

Forwards: A forward contract is an agreement between two parties (buyer and seller of Foreign Exchange) that fixes the terms of a contract of exchange that will take place between them at some future date.

Futures: A futures Contract is a homogeneous forward contract operated on a renowned exchange, requiring the seller to deliver to the buyer, a stated amount of foreign currency at an upcoming date for a price contracted today.

Options: While the forwards or futures contract protects the buyer of the agreement from the unfriendly exchange rate movements, it eradicates the likelihood of gaining a bonus profit from positive exchange rate movement. Option are contract or financial instruments that give owners the right, but not the obligation, to sell or buy a certain quantity of an asset at a specified price at a stated future date.

Swap: The term swap refers to concurrent sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency



Foreign Exchange Market Interventions

A foreign exchange intervention is a monetary policy action that entails a Monetary Authority taking an active participatory function in influencing the monetary funds transfer rate of the domestic currency. Central banks, particularly those in developing countries, intervene in the foreign exchange market in order to shore up reserves, stabilize the exchange rate and to correct misalignments. The achievement of foreign exchange intervention depends on how the central bank sterilizes the effect of its interventions, as well as overall macroeconomic policies set by the State.

The primary dealers (PDM) are institutions licensed by CBN to serve as the market maker in the Foreign Exchange Market. They trade in foreign exchange on their own and on behalf of Individual and institutional clients.

A major feature of the primary market dealer market is the two-way quote system for foreign exchange:

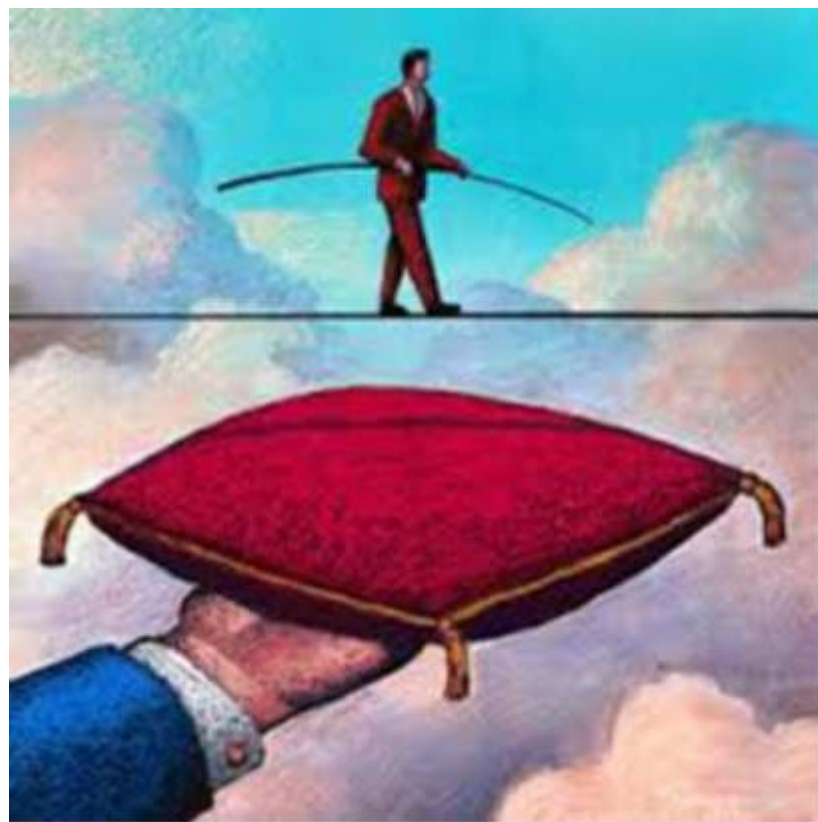
Bids rate: The bid rate (higher yield) is the rate at which the Primary Dealers will purchase foreign exchange.

Offered rate: The Offer rate (lower yield) is the rate the PDM will trade foreign exchange.



Exchange Rate Exposure

Exchange Rate Exposure denotes the risk related to the foreign exchange rates that varies recurrently and can have a negative effect on the financial dealings denominated in foreign currency rather than the local currency of an individual or organization. In other words, the risk that its prospective cash flows get affected by the alteration in the value of the overseas currency, in which it has kept its books of accounts (balance sheet), due to the instability of the foreign exchange rates, is called foreign exchange exposure. It is not only those firms who directly make the financial dealings in the foreign currency denominations that face the risk of foreign exposure, but also, the other organizations who are indirectly related to the foreign currency is exposed to foreign currency risk. For instance, if a Nigerian company is competing against the products imported from China and if the Chinese yuan per Nigerian Naira falls, then the importers relish decreased cost advantage over the Nigerian company. This shows that the firms not having any direct link to the forex, do get affected by the variation in the foreign currency.



Exchange Rate Band

This is the array of exchange rates a monetary authority permits its currency to take. Exchange rate bands are used when one currency relates its value to that of another currency but permits it to vary within certain limits. Exchange rate bands provide a currency a certain level of flexibility so that it can react to market factors while leaving control with the central bank. It is a currency arrangement which establishes a trading range that a currency's exchange rate can hover between. A currency band signifies the lowest and highest level within which the price of a given currency can trade, and it is a mixture of a fixed exchange rate and a floating exchange rate. The currency band confines how much the price can move with respect to a reference currency or currencies. If the value of the currency begins trading outside the band, then the country of that currency will ordinarily return to a fixed exchange rate. A fixed exchange rate is a nation's exchange rate regime under which the government or monetary authority connects the official exchange rate to another country's currency or to the price of gold. The major reason for a fixed exchange rate arrangement is to keep a nation's currency value within a very narrow range. Most major developed countries have had floating exchange rate systems since the early 1970s, whereas developing countries continue to have fixed rate systems. Nevertheless, the system could result in inefficiency and unfair practices in international trade.



Parallel Market Premium

A black or parallel market is an unlawful structure that exists in reaction to government intervention which produces excess supply or demand for a product. Goods obtained illegally may exchange above or below the price of lawful market dealings. They may be cheaper relative to legal market prices. The provider does not have to pay for production expenditures or duties. This is typically the case in the underground economy. Lawbreakers steal goods and sell them below the authorized market price, but there is no receipt, guarantee, and so forth. They may be more costly than legal market prices, because the product may be difficult to procure or produce, hazardous to handle, or not easily obtainable legally. If exchange of goods are made unlawful by some sort of state sanction, their prices will tend to increase as a result of that sanction. When the price of a foreign currency is fixed lower than the market clearing rate, an excess demand is created for the foreign currency. The government has the alternative of either devaluing the currency, or keeping firm controls on exchange, like putting limits on the procurement of foreign exchange. Such currency limits are planned by monetary authorities in order to curtail the usage of foreign exchange in dealings. The difference between the value of a currency in the parallel market and the official market is known as Parallel Market Premium.



Foreign Exchange Market Participants

Major participants in Foreign Exchange Market include Banks (Deposit Money Banks and Central Banks). Also, large corporations, investment and hedge funds, brokerage firms, dealing centers and individuals participate in this process as well:

Authorized Dealers (Deposit Money Banks): Deposit Money Banks carry the main volume of trading. They are involved in taking deposits from individuals and legal entities and operating according to their goals with subsequent return of money to the owners.

Public Sector (Governments): These establishments mainly partake in the foreign exchange market to intervene on behalf of their currency when there is market instability or over or under valuation.

Multinational Corporations: Multi-national corporations need to participate in the foreign exchange market in order to make profits in their home country and to procure raw materials abroad. They make up an important segment of the foreign exchange market.

Correspondent Banks abroad: A correspondent bank is a financial organization that offers services on behalf of another, equal or unequal, financial institution.

Bureau de change: A business body which is out to make its profit by selling currency at a higher exchange rate than a rate at which it purchases the same currency, as well as any commission or fee it may charge is referred to as Bureau de change.



About the Series

“At a Glance” is part of the Central Bank of Nigeria’s literacy series, designed to enlighten users with brief descriptions of basic monetary policy concepts.

The publication presents in a simplified pictorial form, monetary policy concepts in a manner that can be easily understood by users. The pictorial animations make for a more reader friendly presentation. The content will be highly beneficial to all who have a desire to learn the basic concepts of monetary policy, fiscal policy, central banking, financial policy and other related concepts. The book is readily available in libraries across the nation and will be updated as often as required. Enjoy the experience of a well-researched and packaged literacy material.